Financing for Funds and Managers
Omoz Osayimwese

Omoz focuses his practice on the representation of sponsors and investors in the formation and structuring of private equity funds, hedge funds and hybrid funds. He also advises investment managers on strategic transactions involving alternative asset management businesses. Omoz has extensive experience representing sponsors and investors on funds employing credit, distressed investment, buyout, real estate, special opportunities, structured products, activist, multi-strategy and quantitative strategies. Omoz has advised clients on spin-out transactions, acquisitions of minority stakes in hedge fund and private equity firms, joint ventures between investment management firms and strategic transactions involving a change of management of private investment funds. He also represents hedge fund managers and investors in the negotiation of seed-capital transactions, and advises sponsors of private equity firms and hedge fund firms in the structuring of complex carry-sharing arrangements among principals and employees. Omoz's recent representations include institutional sponsors and boutique firms in the formation of private equity funds, hedge funds and hybrid funds; lead investors on their investments in private equity funds; hedge fund managers and investors in seed-capital arrangements; investment managers in joint venture arrangements; and investment managers and investors in the formation of special purpose acquisition and co-investment vehicles.

Omoz is recognized as a leading lawyer by The Legal 500 United States. Omoz speaks regularly to investment managers about current developments relating to private investment funds. He is a contributor to the Fund Formation and Incentives Report (Private Equity International in association with SRZ) and was recently featured in the article “Ringing the Changes,” published in Private Funds Management.

Omoz received his J.D. from University of Michigan Law School and his B.A., with highest honors, from Michigan State University.
Daniel V. Oshinsky

Dan represents hedge funds, private equity funds, asset managers, specialty finance companies and investment banks in a wide range of financing transactions. He has particular expertise in liquidity facilities, such as CLOs, warehouse lines, leveraged finance vehicles, capital call facilities and fund-of-fund loans. Dan’s practice also encompasses a variety of other secured and unsecured finance transactions, both on the borrower and lender side, including cash-flow and asset-based loans, acquisition financing, Term B loans, unitranche loans, workout and restructuring transactions, cross-border transactions and other complex credit arrangements.

Recognized as leader in his field by The Legal 500 United States and New York Super Lawyers, he co-authored Hedge Funds: Formation, Operation and Regulation (ALM Law Journal Press) and has spoken on topics that include investing in corporate credit and leverage for investment funds.

He received his B.A., magna cum laude, from Yeshiva University and his J.D. from New York University School of Law.
Eliot L. Relles

Eliot focuses his practice on commercial and corporate finance transactions and, primarily, the representation of hedge funds, private equity funds, commercial finance companies and investment banks in domestic and cross-border secured and unsecured finance transactions, including asset-based and cash flow financings, acquisition and leveraged buyout financings, subordinated and mezzanine financings, first-out/last-out, second lien and tranche B financings, and debtor-in-possession and exit financings. He also counsels clients in debt restructuring and general corporate finance matters, and has represented clients in connection with commercial loan securitizations and capital commitment lines of credit.

Recognized by New York Super Lawyers as a leading finance lawyer, Eliot has spoken on topics of interest to the investment management community, including on distressed investing in the retail industry and dividend recapitalizations.

Eliot received his J.D. from Hofstra University School of Law, where he was associate editor of the Hofstra University Law Review, and his B.A. from the University of Michigan.
Craig Stein

Craig co-heads Schulte Roth & Zabel's Structured Finance & Derivatives Group. His practice focuses on swaps and other derivative products, including credit- and fund-linked derivatives, prime brokerage and customer trading agreements, and structured finance and asset-backed transactions. He represents issuers, underwriters, collateral managers and portfolio purchasers in public and private structured financings, including collateralized loan obligations (CLOs).

Chambers USA has noted that satisfied clients have praised Craig for his “very broad knowledge of the markets” and for being “incredibly responsive and helpful in thinking through issues” and “very thoughtful about the market.” Chambers also notes, “He is known for his work in derivative products, representing issuers, underwriters and portfolio purchasers in CLOs. Peers find his work in structured products and derivatives impressive.” The Legal 500 United States has noted that Craig is “recognized for his thought leadership on regulatory issues affecting both the securitization and derivatives markets.” He is also recognized as a leader in his field by Chambers Global and Expert Guide to the World’s Leading Banking, Finance and Transactional Law Lawyers (Structured Finance and Securitization). Craig is a member of the American Bar Association, the New York City Bar Association, the New York State Bar Association, the Loan Syndications and Trading Association, the International Swaps and Derivatives Association and the Structured Finance Industry Group. He is a much sought-after speaker for hedge fund industry conferences and webinars and the author of numerous articles on advanced financial products. He recently authored “U.S. CLOs: Past and Present,” published in The Journal of Structured Finance, and is co-author of “CLOs and Risk Retention in the U.S. and EU: Complying with the Rules,” published in The International Comparative Legal Guide to: Securitisation 2016. He spoke on how alternative asset managers and banks work together post-Basel III and on the latest trading-related compliance and enforcement concerns.

Craig earned his J.D., cum laude, from the University of Pennsylvania Law School and his undergraduate degree, cum laude, from Colgate University.
Financing for Funds and Managers

I. Warehouse Facilities

A. Creation and Purpose of Warehouse Facilities

1. A warehouse facility can be used to finance the purchase and origination of a variety of commercial loans and many other asset classes.

2. Warehouse facilities may provide short-term financings and are often used to “ramp-up” to a CLO. If the warehouse will terminate upon the closing of a CLO, the warehouse SPV can be used as the CLO vehicle, and the fund manager avoids having to transfer assets from one vehicle into a new vehicle at CLO closing. A warehouse facility may also be a permanent facility for the fund, although an exit to a CLO is still feasible, and is often contemplated in an exception to a facility's sale restrictions. However, in that case, assets will have to be transferred from the warehouse vehicle into the CLO issuer.

3. To create a warehouse facility, a fund forms a special purpose vehicle (SPV), contributes an initial pool of assets (which could include cash) to the SPV, and then uses its equity and third-party financing to expand the pool.

B. Structuring Warehouse Facilities

1. The borrower/SPV is designed to be bankruptcy remote. Several features that are built into the organizational documents of the borrower that support the bankruptcy remoteness of the subsidiary include:

   (a) An independent director or manager whose consent is needed for a bankruptcy filing or other material action;

   (b) “Separateness provisions” that require the borrower to maintain separate books and records, and a separate identity from affiliates; and

   (c) Limited purpose provisions to limit the scope of creditors.

2. As a result of In re Gen. Growth Props., 409 B.R. 43, 71 (Bankr. S.D.N.Y. 2009) (secured lenders sought dismissal of special purpose entity Chapter 11 cases arguing that surreptitious dismissal of independent directors on the eve of bankruptcy constituted “bad faith filings”; bankruptcy court denied motions to dismiss because, among other things, “corporate documents did not prohibit this action or purport to interfere with the rights of a shareholder to appoint independent directors to the Board.”), lenders will require that organizational documents of the SPV limit independent directors to employees of recognized securitization service providers and only allow replacement of an independent director “for cause.”

3. Warehouses may be highly structured facilities, with many elements of a CLO, such as:

   (a) SPV borrower;

   (b) Collateral quality and coverage tests;

   (c) Priority of payment waterfalls; and
(d) Debt under the warehouse facility may be rated, and the lender may require the underlying loans to be shadow rated, as in a CLO. However, it’s rare to have multiple tranches of debt, and typically the lender group is small. Many warehouse facilities in fact do not have rated debt.

4. Warehouse facilities incorporate a predetermined list of eligibility criteria and concentration limits for the SPV’s assets, which are generally formulated based on a target asset pool and the lender’s credit parameters. Some lenders insist on retaining an approval right for each asset added to the warehouse and, therefore, under such facilities, the lender is only quasi-committed.

5. Other ways warehouses remain distinct from capital markets deals include:

   (a) Documentation under a credit agreement or using a total return swap (TRS) instead of a bond indenture;

   (b) “Club deals” with a limited number of finance providers;

   (c) More likely to be a U.S.-based issuer instead of Cayman-based; and

   (d) Administrative agent plays active role in approving portfolio and actions by the collateral manager.

6. Other features of a warehouse:

   (a) Assets are held in an SPV owned by the fund (and not “warehoused” on the books of an investment bank, which was common before the credit crisis).

   (b) Facilities may have longer revolving periods (as long as three years) followed by an amortization period.

   (c) Recourse is limited to the asset pool. Hedge fund sponsors typically are not required to guaranty repayment of the warehouse debt, even if a planned CLO fails to launch.

7. Risk Retention

   (a) U.S. risk retention rules became effective for CLOs on Dec. 24, 2016. Whether a warehouse facility is subject to the risk retention rules can be a complicated analysis and a market consensus as to the treatment of warehouse facilities under the U.S. rules has not yet developed.

   (b) European risk retention rules have been in effect for several years. European arrangers of warehouse facilities (including their U.S. affiliates) have generally taken the view that warehouse facilities are subject to the European risk retention rules.

II. Leveraging Commitments and Employee Capital; Other Credit Facilities

   A. Capital Call Lines and Subscription Facilities

   1. General

      (a) These facilities are typically used to bridge an investment to be made by a private equity fund prior to receipt of proceeds of capital calls and also occasionally to fund working capital needs of a private equity fund (e.g., to pay fund expenses, including management fees). They are
also increasingly being used as more conventional longer-term financing for investments. A subscription facility may also be used to provide standby letters of credit. In certain types of facilities, drawdowns are required to be repaid within a short period (e.g., between 90 days and 180 days). This may be required to meet tax structuring needs (such as where the fund has UBTI-sensitive investors) or may be a credit criteria imposed by the lender. In other cases, drawdowns will not be required to be repaid until final maturity.

(b) Typically, a security interest on portfolio assets is not taken; instead, the fund's general partner pledges its right to call capital from commitments to the lender, and limited partners agree (usually pursuant to the partnership agreement of the fund and sometimes through the execution of separate confirmation letters) that their unfunded capital commitments can be called directly by a lender to repay amounts drawn under the facility. Thus, the loan facility is secured by unfunded capital commitments of the limited partners (as well as the collection account for capital contributions). Occasionally, in situations where the fund is near the end of its investment period and unfunded capital is relatively low, the lender may also take a security interest in fund assets.

2. Obligations of Limited Partners

Limited partners are usually required under the fund’s partnership agreement to provide financial information about themselves so that the lender can assess individual limited partners’ credit. Some limited partners (e.g., certain pension funds or foundations) enter into side letters with a fund pursuant to which they agree only to provide publicly available financial information about themselves. In addition, certain tax-exempt limited partners who want minimal UBTI risk will enter into side letters with the fund that provide that they will be given the chance to pre-fund (usually on notice shorter than the notice required for capital calls) their share of any drawdown from a subscription facility and such limited partners usually also request that no portion of the interest expense charged on the fund’s drawdown from the subscription facility will be allocable to a limited partner that has pre-funded its share of such drawdown from the subscription facility. Private equity funds also frequently agree with limited partners to side letter provisions that limit the subscription facility documentation required by a lender to be executed by such limited partners to “customary” documentation and/or documentation “reasonably satisfactory” to such limited partners.

3. Terms of Borrowing

(a) The borrowing base (i.e., the amount of funds that can be drawn down under a subscription facility) is typically equal to a percentage of the unfunded capital commitments of eligible (or “included”) limited partners. Limited partners that do not provide sufficient financial information about themselves, or whose credit the lender deems insufficient, are typically excluded from the borrowing base. The default or bankruptcy of a single eligible limited partner should not result in default if outstanding loans are less than the amount of borrowing base. However, if the facility is provided to a “fund of one,” a default or bankruptcy event affecting the investor would result in all loans becoming due and an inability to borrow going forward, because the borrowing base will be zero. Note that, even though some investors are not included in the borrowing base because the lender is not sufficiently satisfied with their creditworthiness, the GP would still be pledging its right to call capital from such investors.

(b) The advance rate on drawdowns may be a blended rate that takes into account different advance rates for different limited partners in the borrowing base (e.g., limited partners with higher ratings effectively get to borrow a higher percentage of their collateral). In addition to interest on amounts drawn down from the subscription facility, lenders may also charge a facility fee payable at closing, as well as an unused commitment fee.
Because lenders are primarily relying on the capital commitments, rather than on the value of the borrower’s assets, a subscription facility should include fewer restrictions and controls over a fund's business (which restrictions and controls may be typical in a more typical corporate credit facility). A subscription facility, however, will include many provisions relating to the investors (such as restrictions on transfers and withdrawals by investors or excusing an investor’s obligation to fund, limitations on who may become an investor and restrictions on amendments to the partnership agreement or entering into new side letters). Usually, the restrictions are tighter for the investors included in the borrowing base, although since all investor commitments are pledged, the lender may still insist on some control over certain actions relating to excluded investors.

4. Other Advantages to Using Subscription Facilities; Longer-term Facilities

(a) Sometimes, funds prefer to draw down funds under a subscription facility rather than call capital directly from the fund’s investors because, in many instances, the preferred return on an investor’s capital contribution to a fund only starts ticking when the capital contribution is actually made. If the interest rate at which the fund can borrow from a lender is low compared to the preferred return rate, managers may prefer to keep money drawn down by a fund under a subscription line facility outstanding (and unpaid) for a longer period of time than would otherwise be the case.

(b) The effective interest rate charged on borrowings under a subscription line facility is, in part, based on the creditworthiness of institutional investors who may be investors in the fund. Some of the large institutional investors in private equity funds have very good credit ratings and because of these good credit ratings, it may therefore be possible for a subscription line facility to charge a lower interest rate than would be available for a borrowing to finance fund investments where such investments are pledged as collateral for the lender. A consequence of the foregoing is that some funds are using longer-term capital call lines, particularly when the fund has no UBTI-sensitive investors, in lieu of more traditional asset-based borrowing by the fund.

B. Leveraged Co-investment Arrangements

1. General

(a) Investors in private equity funds usually want the fund’s investment team to be aligned with investors by having “skin in the game” and will, therefore, often require investment team members (either individually or collectively) to make capital commitments to the private equity fund. A manager may also want the investment team for a particular fund to participate in the fund’s P&L through an actual investment (i.e., capital commitment) in the fund.

(b) Leveraged co-investment arrangements provide a means for a manager to facilitate loans from a lender to the employees and principals of a private equity fund manager to fund capital commitments to be made by such employees and principals to a private equity fund. Managers with sufficient internal capital may loan money to employees to fund employees’ capital commitments under a similar arrangement. More typically, a manager will arrange for a lender to provide loans to employees to make capital commitments. Private banks and the private banking units of larger banks are typically the types of lenders who offer leveraged co-investment arrangements.
2. Terms of Borrowing

Loan advances are typically made each time the private equity fund makes a capital call and an employee’s partnership interest in the private equity fund is usually pledged as collateral to the manager, who then guarantees repayment of the loan to the lender. The manager, in turn, then typically pledges to the lender its right to receive management fees. A more manager-friendly option is for the employees to pledge their interest in the private equity fund directly to the lender. Proceeds from any distribution (other than distributions subject to reinvestment) are usually paid directly to the lender to repay principal on the loan and the lender often requires employees participating in the leveraged co-investment to maintain bank accounts with the lender.

3. Structure

(a) Instead of having employees invest directly in the fund, sometimes the manager will establish solely for employees:

(i) A parallel fund in which the loan advances will be invested, which parallel fund will invest alongside the main private equity fund; or

(ii) A feeder fund in which loan advances will be invested and which will, in turn, invest substantially all of its capital into the main private equity fund.

(b) The parallel fund option may not necessarily be economically efficient since it would necessitate allocating investments across funds, which entails additional operational costs that are not incurred with a feeder fund structure.

4. Regulatory Requirements

For securities law purposes employees will need to be accredited investors under Regulation D, and since many private equity funds rely on the Section 3(c)(7) exemption to the Investment Company Act, employees also typically need to be “qualified purchasers” or “knowledgeable employees.”

C. Management Company Facilities

1. Management companies sometimes borrow money from lenders in order to meet their working capital needs, which may include paying employee salaries and bonuses. In some instances, the manager/GP of a fund may have significant unrealized carried interest or incentive allocations in the fund which, upon realization, could help pay employee compensation. In such instances, it may be inconvenient or impractical to sell investments in order to have cash to pay compensation and the manager may instead choose to borrow funds to compensate employees.

2. Management company borrowings are usually secured by granting the lender a security interest in management fees. This kind of secured borrowing by the management company can create concerns for investors who may be worried that if the management company defaulted on such borrowings and the lender started receiving the management fees that the management company would otherwise have been entitled to receive, then the management company would not be able to cover its ordinary operating expenses (e.g., salaries, rent, utilities, etc.) and perform its core function as investment adviser to the applicable fund. This is one reason why management company borrowings are often for relatively small amounts.
III. Master Repurchase Agreements

A. Basic Terms of Repo

1. Under a repo, the fund sells assets to the repo counterparty for cash with an agreement by the fund to repurchase the assets at the end of the term. During the term of the trade, the fund will pay a financing fee to the counterparty, known as the price differential in repo parlance. Cash flows on the asset get paid by the counterparty to the fund (net of the price differential) during the term of the trade.

2. Market-value financing: Repos are typically market-value financing arrangements whereby the fund will be required to deliver margin or collateral if the market value of the asset declines. But depending on asset and business deal, they don’t have to be.

3. Complex repos are documented under non-standard negotiated agreements similar to traditional asset-based credit agreement financings (as opposed to industry standard MRA and GMRA for treasuries).

4. Custodial arrangements: Many repos have assets deposited with a custodian, thereby protecting the fund against dealer credit risk. If there is no custodian, the dealer has the right to rehypothecate the assets; but are still required to sell back the assets at termination.

B. Legal Considerations

1. Master repurchase agreements receive special treatment under the U.S. Bankruptcy Code. There are safe harbor provisions that allow a counterparty to liquidate, terminate and accelerate a contract outside of the automatic stay provisions of the Bankruptcy Code.

2. Safe harbor bankruptcy for repurchase agreements and securities contracts:
   (a) Section 555 of the Bankruptcy Code — contractual right to liquidate, terminate or accelerate a securities contract;
   (b) Section 559 of the Bankruptcy Code — contractual right to liquidate, terminate or accelerate a repurchase agreement;
   (c) Section 561 of the Bankruptcy Code — contractual right to terminate, liquidate, accelerate or offset under a master netting agreement and across contracts; proceedings under Chapter 15; and
   (d) Section 362(b)(6) of the Bankruptcy Code — contractual rights, including right to offset or net out any termination value, payment amount, or other transfer obligation, under any security agreement or arrangement or other credit enhancement forming a part of or related to any commodity contract, forward contract or securities contract.

3. Section 101(47) of the Bankruptcy Code — Definition of “Repurchase Agreement”

The term “repurchase agreement” (which definition also applies to a reverse repurchase agreement)

(a) Means:

   (i) An agreement, including related terms, which provides for the transfer of one or more certificates of deposit, mortgage related securities (as defined in Section 3 of the
Securities Exchange Act of 1934), mortgage loans, interests in mortgage-related securities or mortgage loans, eligible bankers' acceptances, qualified foreign government securities (defined as a security that is a direct obligation of, or that is fully guaranteed by, the central government of a member of the Organization for Economic Cooperation and Development) or securities that are direct obligations of, or that are fully guaranteed by, the United States or any agency of the United States against the transfer of funds by the transferee of such certificates of deposit, eligible bankers' acceptances, securities, mortgage loans, or interests, with a simultaneous agreement by such transferee to transfer to the transferor thereof certificates of deposit, eligible bankers' acceptance, securities, mortgage loans, or interests of the kind described in this clause, at a date certain not later than one year after such transfer or on demand, against the transfer of funds;

(ii) Any combination of agreements or transactions referred to in clauses (1) and (3);

(iii) An option to enter into an agreement or transaction referred to in clause (1) or (2);

(iv) A master agreement that provides for an agreement or transaction referred to in clause (1), (2) or (3), together with all supplements to any such master agreement, without regard to whether such master agreement provides for an agreement or transaction that is not a repurchase agreement under this paragraph, except that such master agreement shall be considered to be a repurchase agreement under this paragraph only with respect to each agreement or transaction under the master agreement that is referred to in clause (1), (2) or (3); or

(v) Any security agreement or arrangement or other credit enhancement related to any agreement or transaction referred to in clause (1), (2), (3) or (4), including any guarantee or reimbursement obligation by or to a repo participant or financial participant in connection with any agreement or transaction referred to in any such clause, but not to exceed the damages in connection with any such agreement or transaction, measured in accordance with Section 562 of this title; and

(b) Does not include a repurchase obligation under a participation in a commercial mortgage loan.

4. Section 741 of the Bankruptcy Code — Definition of “Securities Contract”

“Securities contract”

(a) Means:

(i) A contract for the purchase, sale or loan of a security, a certificate of deposit, a mortgage loan, any interest in a mortgage loan, a group or index of securities, certificates of deposit, or mortgage loans or interests therein (including an interest therein or based on the value thereof), or option on any of the foregoing, including an option to purchase or sell any such security, certificate of deposit, mortgage loan, interest, group or index, or option, and including any repurchase or reverse repurchase transaction on any such security, certificate of deposit, mortgage loan, interest, group or index, or option (whether or not such repurchase or reverse repurchase transaction is a “repurchase agreement,” as defined in Section 101);

(ii) Any option entered into on a national securities exchange relating to foreign currencies;
(iii) The guarantee (including by novation) by or to any securities clearing agency of a settlement of cash, securities, certificates of deposit, mortgage loans or interests therein, group or index of securities, or mortgage loans or interests therein (including any interest therein or based on the value thereof), or option on any of the foregoing, including an option to purchase or sell any such security, certificate of deposit, mortgage loan, interest, group or index, or option (whether or not such settlement is in connection with any agreement or transaction referred to in clauses (1) through (11));

(iv) Any margin loan;

(v) Any extension of credit for the clearance or settlement of securities transactions;

(vi) Any loan transaction coupled with a securities collar transaction, any prepaid forward securities transaction, or any total return swap transaction coupled with a securities sale transaction;

(vii) Any other agreement or transaction that is similar to an agreement or transaction referred to in this subparagraph;

(viii) Any combination of the agreements or transactions referred to in this subparagraph;

(ix) Any option to enter into any agreement or transaction referred to in this subparagraph;

(x) A master agreement that provides for an agreement or transaction referred to in clause (1), (2), (3), (4), (5), (6), (7), (8) or (9), together with all supplements to any such master agreement, without regard to whether the master agreement provides for an agreement or transaction that is not a securities contract under this subparagraph, except that such master agreement shall be considered to be a securities contract under this subparagraph only with respect to each agreement or transaction under such master agreement that is referred to in clause (1), (2), (3), (4), (5), (6), (7), (8) or (9); or

(xi) Any security agreement or arrangement or other credit enhancement related to any agreement or transaction referred to in this subparagraph, including any guarantee or reimbursement obligation by or to a stockbroker, securities clearing agency, financial institution, or financial participant in connection with any agreement or transaction referred to in this subparagraph, but not to exceed the damages in connection with any such agreement or transaction, measured in accordance with Section 562; and

(b) Securities contract does not include any purchase, sale or repurchase obligation under a participation in a commercial mortgage loan.

IV. Total Return Swaps

A. General

Total return swaps are an effective financial tool for private investment funds that want to obtain leverage on their investments in a variety of asset classes, including corporate loans, bonds or even other hedge funds (“reference assets”). Total return swaps enable investment funds to obtain the economic exposure to a reference asset or a portfolio of reference assets on a leveraged basis without taking ownership of the reference assets. The investment fund will receive all of the cash flow benefits of the reference assets without actually owning them. At the end of the transaction, or at predetermined time periods, the investment fund will make a payment to the swap dealer in an amount
equal to the decline of the reference assets or the swap dealer will make a payment to the investment fund in an amount equal to the increase in value of the reference assets. During the life of the transaction, the investment fund will receive from the swap dealer all cash flows received on the reference assets and in exchange, the investment fund will make periodic payments to the swap dealer equal to the financing cost of an investment in the reference assets.

B. Ancillary Benefits to Total Return Swaps

There are other reasons for investment funds to utilize total returns swaps, although they are typically ancillary to the main reason, leverage. Other reasons include the ability to outsource the administration and operation of trading and maintaining the reference assets, and the ability to gain exposure to reference assets that an investment fund might not otherwise be able to own due to, for example, eligibility restrictions on ownership and issuer consent rights to any transfer. If the total return swap is characterized as a derivatives contract instead of as a secured financing, there are additional benefits. Typically the swap dealer will not incur a substantial regulatory charge if derivative accounting treatment is achieved. In addition, in the case of a bankruptcy of the investment fund, certain swap agreements are exempt from the automatic stay imposed by the Bankruptcy Code, and the swap dealer may be permitted to terminate and liquidate the transaction outside of the bankruptcy proceeding. These features will enable the swap dealer to provide the investment fund better financing terms.

C. Downside of Total Return Swaps — Voting Rights

Although the investment fund does not have legal ownership of the reference assets, the swap dealer may, for purposes of its hedge, acquire the reference assets. Accordingly, one issue typically negotiated is if, and to what extent, an investment fund will have the right to direct the swap dealer on how to vote on any issues that arise with respect to the reference assets (e.g., votes on amendments to financial covenants, changes to economic terms, etc.). Voting rights are especially important when dealing with reference assets that become defaulted obligations because of a payment default or bankruptcy of the issuers if the investment fund manager wants to control or have some input in dealing with the defaulting obligors. Note that typically the swap dealer has a strong desire to achieve derivative accounting treatment. While there is no bright line rule to ensure derivative treatment, providing the investment fund the sole unfettered right and discretion to direct the swap dealer on voting issues with respect to the reference assets is not a good fact in achieving the desired derivative treatment. Therefore, any voting rights that are passed along to investment funds typically take the form of consultative rights if the investment fund is granted any rights at all.

D. Issues to Consider for TRS Facilities

1. Committed versus non-committed facilities;
2. Recourse versus limited recourse facilities;
3. Market value triggers; and
4. Certain tax considerations: The tax considerations related to a private investment fund’s investment in total return swaps are influenced by, among other factors, the fund’s jurisdiction, level of trading activities and/or investor base.

E. Dodd-Frank Act

Under the Dodd-Frank Act, a total return swap on a single loan or security is a “security based swap” and a “security,” and is now subject to the jurisdiction of the SEC and the anti-fraud and anti-
manipulation provisions of the Securities Act and the Exchange Act. In addition, total return swaps on a single loan or security must be traded with a counterparty that is an “eligible contract participant” unless there is an effective registration statement for the swap. A total return swap on a portfolio of loans or securities is probably not a “security-based swap,” but is a “swap” under the Dodd-Frank Act and, therefore, subject to the jurisdiction of the CFTC and the anti-manipulation provisions of the CEA. Swaps are subject to business conduct standards, reporting and recordkeeping requirements and margin rules and regulations.

F. Safe Harbors

1. Like repos, swaps are also subject to safe harbors from bankruptcy intended to achieve market stability and to decrease systemic market risk by minimizing the effects of a major bankruptcy in the marketplace. The safe harbors prevent the bankruptcy trustee from avoiding margin and settlement payments to other counterparties. Section 362(b)(17) denotes that automatic stays will not apply to swaps; Section 546(g) prevents the bankruptcy trustee from avoiding transfers under a swap; and Section 560 states that default (ipso facto) clauses based on bankruptcy can be enforced by their swap counterparties against the trustee. Master netting agreements are also subject to these same safe harbor clauses via Sections 362(b)(27), 546(j) and 561, respectively.

2. There have been criticisms of these safe harbors. The current broad safe harbors may deny the debtor the ability to assume valuable executory contracts, like swaps, and thus contradict a basic purpose behind bankruptcy policy. Systemic risk might actually be increased where counterparties (with less incentive to monitor the debtor pre-bankruptcy due to its decreased fear of debtor avoidance) could demand successively increasing levels of collateral from the debtor as its financial condition worsens, causing a run on the debtor and exacerbating the market conditions.

3. In the EU, recent legislation called the Bank Recovery and Resolution Directive (or BRRD) gives broad powers to resolution authorities to managing failing financial institutions, including the ability to write down debt owed to creditors, convert debt to equity and to impose temporary stays on termination rights. Having an effective stay upon early termination rights (including suspension of payment and delivery obligations and a stay on the enforcement of security obligations) is viewed as important in preventing the close-out of financial contracts in larger numbers during the resolution period, where the objective of maintaining critical functions and a balanced book could become disrupted. In order to address cross-border recognition of such powers, the EU requires that regulated entities provide for a clause in non-EU law governed contracts whereby creditors recognize the bail-in or temporary stay powers of the EU resolution authority, although it should be noted that BRRD itself doesn’t require contracts to recognize the resolution stay (only the bail-in), but instead the EU Member States themselves have committed to coordinated efforts to introducing contractual stay requirements in their own jurisdictions. The stay period varies according to the jurisdiction, where, for example, some jurisdictions maintain a 48-hour period, and others maintain a period lasting until the end of the next business day.

4. While it is clear that a given regulator’s “resolution stay” powers can be enforced within its own jurisdiction, it is not clear that they would be enforced outside such jurisdiction (for example, by U.S. courts analyzing N.Y. law-governed swap agreements). In 2016, the ISDA Resolution Stay Jurisdictional Modular Protocol was launched to facilitate adherence with the various contractual stay requirements. The terms of any contractual amendments (including specifics such as types of agreements and defaults) will vary from module to module depending on the member state’s jurisdictional requirements. Each dealer will be asking counterparties to adhere to the modules related to the resolution stay requirements to which it is subject. While entering into the Jurisdictional Modular Protocol is required in order to transact with such EU-regulated dealers, it
should be understood that doing so requires giving up rights and remedies that might otherwise be available in the United States.

5. In the United States, the FDIC recently submitted a notice of proposed rulemaking that would restrict contractual provisions on qualified financial contracts (including swaps) entered into by FDIC-supervised institutions that are subsidiaries of U.S. and non-U.S. “systemically important banking organizations.” These restrictions would extend to contracts entered into with non-covered parties, such as hedge funds. In order to address what it perceives as obstacles to orderly resolution under bankruptcy, the FDIC’s proposed rulemaking would require covered entities to contractually agree that cross-default rights under a qualified financial contract could not be used in connection with a bankruptcy proceeding. Currently, the proposed rule is not limited to only contracts under non-U.S. law, so potentially all swaps and related contracts with a regulated dealer could be covered, and the current statutory bankruptcy stay safe harbors could be eliminated. The proposed rulemaking is currently in its review and comment period.

V. Fund-of-funds Facilities

A. Nature of Collateral

1. Fund-of-funds financings are a unique, specialized lending area due to the nature of the collateral. A fund-of-funds is a fund that invests in other hedge funds. The sole collateral under a fund-of-funds facility will be:

   (a) The fund-of-funds' interests in the underlying hedge funds; and

   (b) The accounts into which redemption proceeds and distributions are paid to the fund-of-funds.

2. A lender has to assess not just whether the underlying funds are good investments, but also the difficulty of realizing upon the collateral. Realizing on the collateral may be difficult without cooperation of the fund-of-funds borrower.

3. Withdrawal/redemption restrictions have to be assessed, as well as transfer restrictions. The lender will look at “gates,” suspensions and lock-ups, as well as provisions that permit in-kind distributions.

B. Role of Underlying Hedge Funds

1. In the past, lenders required upfront consent from the underlying hedge funds. The consent authorized the pledge, provided for admission of the lender and provided for redemption or withdrawals by the lender. The primary problem with this approach was a lack uniformity among consent forms.

2. Currently, a fund-of-funds generally holds its fund interests through a nominee. The nominee’s interest is held through a securities account, as described below. It is noteworthy that lenders retain tight control on withdrawals. This can hinder a fund-of-funds’ ability to access its cash.

C. Structure of Fund-of-Funds Facilities

1. Fund-of-funds facilities are typically structured as revolving credit facilities secured by the underlying portfolio of fund interests. Custodial control arrangement is entered into through the creation of a perfected security interest in a securities account to which the underlying fund interests are credited. In addition, the lender obtains a perfected security interest in the deposit accounts into which redemption proceeds are placed.
2. Account control agreements are entered into with the borrower and the custodian bank that holds the accounts.

3. The fund interests are held in the name of the lender or custodian to facilitate redemptions without borrower consent. This structure can create problems for borrowers due to constraints on transferring interests and accessing proceeds of distributions and redemptions.

4. Lending formulas are generally tied to values of the underlying investments and function as a variant of a typical borrowing base. The lending formula caps the lender’s exposure to a percentage of the actual collateral values. The formula might be determined by taking the aggregate collateral value and multiplying by a maximum risk ratio. The risk ratio will incorporate a haircut formula that can be lengthy and will be customized to the fund-of-funds’ strategy.

5. Maturities vary from one year to longer; some lenders wish to review the facility annually before deciding whether to renew.

D. Use of Loan Proceeds

1. Loan proceeds are used for a variety of purposes:

   (a) Finance further investments in pledged funds or new funds;

   (b) Finance redemptions, especially larger than anticipated redemptions; and

   (c) General liquidity (which may be left untapped).

E. Specialized Provisions

1. Fund-of-funds facilities have tests that allow the lender to react quickly to problems with the portfolio. Some examples include:

   (a) Volatility tests (look at variations in standard deviations of NAVs);

   (b) NAV and net equity tests (look at the high point during a specified period and then require a certain percentage of high point to be met);

   (c) Diversification tests (minimum number of funds and maximum allocation per investment fund or manager; possibly also by type of strategy); and

   (d) Material adverse effect tests (will test for adverse changes affecting the fund, the general partner, investment manager and the portfolio).