GLI GLOBAL LEGAL INSIGHTS

Fund Finance

2021

Fifth Edition

Contributing Editor: **Michael C. Mascia**

glg global legal group

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Derivatives at fund level

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Overview

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

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

Introduction

There are a wide variety of reasons why a manager may consider entering into derivatives transactions, but derivatives use can generally be split between those of a speculative nature and hedging. At one end of the spectrum, funds can use derivatives to speculate in the active pursuit of investment return (for example, using total return swaps as a form of leverage to increase the funds' exposure to a particular asset) and, in so doing, may be expected to enter into a wide array of derivatives transactions.

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

Sometimes a fund's exposure to a particular risk is indirect, and it is more appropriate for the relevant derivatives to be entered into below fund level. A common example is interest rate hedging for an acquisition finance facility in the context of a private equity transaction.

The buyer under the relevant acquisition will be a vehicle established by the fund to make the acquisition. It is this vehicle that would enter into any acquisition finance facility to assist in funding the acquisition. Consequently, it is this vehicle that is exposed directly to any interest rate fluctuations on that facility; the fund is only indirectly exposed through its ownership of the vehicle.

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

Potential advantages and disadvantages of entering into derivatives at fund level

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

Main advantages of entering into derivatives at fund level

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

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

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

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

Main disadvantages of entering into derivatives at fund level

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

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

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

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

Consequently, careful analysis of any regulatory obligations needs to be made by any manager who is considering entering into derivatives at fund level. For example, in June 2019, EMIR was amended (referred to hereafter as EMIR Refit) and one of the key changes was to broaden the definition of "Financial Counterparties" (parties that are in-scope for material obligations such as mandatory posting of variation margin), the effect of which is to capture a broader range of funds than was previously the case.

However, EMIR Refit has also provided for a carve-out from the variation margin requirement in respect of certain types of over-the-counter (OTC) derivatives, which is expected to benefit most funds: the mandatory exchange of variation margin on physically settled FX forwards and physically settled FX swaps now applies only to transactions between "the most systemic counterparties". "The most systemic counterparties" only refer to credit institutions and MiFID investment firms established in the EEA (or equivalent entities located in a third country) and so would not capture most funds. EMIR Refit has also created a new "Small Financial Counterparty" classification, exempting certain financial counterparties from the requirement to clear their trades, so smaller funds that use interest rate derivatives (of a type that otherwise would need to be cleared) may be able to sidestep the clearing obligation.

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

There may be additional regulatory considerations in the event of a no-deal Brexit which, at the time of writing this chapter, remains a possibility. An example of this would be the possible divergence between regimes as a result of how EMIR will apply to EU managers and EU counterparties post-Brexit and how the UK onshored version of EMIR will operate and will be enforced by the relevant authorities, following the transition from EU to UK competence. While most of the immediate implications are known and are largely manageable for funds (to give one example, UK managers will need to ensure that details of their transactions are reported to a UK authorised trade repository, as they will no longer be able to report to an EU authorised trade repository), there is the potential for drift between the regimes over time, so managers are advised to work with their legal counsel to stay abreast of potential implications for their funds.

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

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

A further consideration for funds subject to the Alternative Investment Fund Managers Directive (AIFMD) is whether the use of derivatives at fund level would create leverage within the fund, and the extent to which this may be undesirable. At the time of writing this chapter, consultations are taking place within the EU regarding leverage rules, though detailed consideration of these issues sits outside the focus of this chapter.

Constitutional considerations when entering into derivatives at fund level

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

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

Constitutional limitations in relation to entering into derivatives transactions

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

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

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

(b) *Prohibition from entering into speculative derivatives*. Here, the manager will need to consider carefully the nature of the derivatives to be entered into by the fund and whether, on a correct construction of the limitation language, they could be caught. For example, a derivatives transaction entered into to hedge interest rate exposure on a fund-level loan may not be speculative, as it is hedging a genuine risk faced by the

fund. However, if the loan is repaid but the derivatives transaction remains outstanding (or if the nominal value hedged is not reduced in line with repayments of the loan), then have the derivatives become speculative? What if the facility under which the loan has been drawn and repaid is revolving and it is likely that the facility will be redrawn? Similarly, if a derivatives transaction entered into at fund level is not hedging a risk to which the fund is directly exposed, but instead hedging a risk to which the fund is only indirectly exposed – for example, a risk to which an investee company is exposed – then would this alone cause the derivatives transaction to be categorised as speculative?

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

<u>Constitutional limitations in relation to granting credit support for derivatives transactions</u>

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

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

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

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

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

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

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

The manager will also need to consider any ongoing requirements under the proposed derivatives transaction to make payments or to post collateral. The proposed source of any

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

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

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

The extent of any contractual restrictions will be a matter for the fund to determine by reference to the specific finance documents that it has in place. For mid-sized and smaller funds, the starting position would be to assume that any credit agreement on reasonably market-standard terms will restrict the fund's ability to incur debt, give guarantees and grant security – subject to a relatively narrow suite of permissions and a general permission "basket". This is considered below in more detail. For larger funds, any credit agreement may be less restrictive, but managers should nonetheless carefully consider whether any of the following apply.

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

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

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

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

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

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

(a) *Security*. Fund finance documents will invariably include a negative pledge that limits the fund's ability to grant security. This restriction will certainly apply to security over

the investors' uncalled commitments and any collateral or deposit account into which any investor commitments are paid when called, but it will usually apply to the creation of other security as well. The manager will need a clear understanding of how any such limitation operates.

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

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

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

(d) *Priority arrangements*. As a precondition to the manager successfully negotiating permissions under its credit agreement for the fund to enter into derivatives (and any related security or guarantees), the credit agreement may require that the derivatives counterparty joins into a priority agreement that regulates the relative ranking of the rights of the lenders under their loans, and of the derivatives counterparty under the derivatives. Such priority arrangements are, however, rarely seen – probably because: (i) subscription lenders are prepared to rely on their security over the investors' uncalled commitments and general fund NAV; and (ii) other lenders at the fund level would satisfy themselves that any such exposure was limited by ensuring that any baskets permitting such activities were relatively low.

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

A shared security package between a fund's lenders and its hedge counterparties

Fund-level derivatives usage can broadly be divided into two categories: secured and unsecured. The term "secured" is primarily used to refer to a scenario where the derivatives counterparty is party to security arrangements given in favour of the fund's lenders (and often such derivatives counterparty is also a lender (or an affiliate of a lender) under the fund's facility). Somewhat unhelpfully, the term "unsecured" is often used where the fund's documentation envisages collateralisation of the derivatives (and such collateralisation can be colloquially referred to as security).

Where a fund is considering secured hedging and the facility lenders are amenable to sharing their security with the derivatives counterparties, the security package would be granted in favour of a security agent, which holds that security on trust for both the lenders and the derivatives counterparties. The benefit of any guarantee granted in favour of the lenders under the credit agreement and associated security documents would also be extended to the derivatives counterparties.

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

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

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

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

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

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

There are a number of other potential points of interaction between a fund's credit agreement and its derivatives documents (and these considerations apply to both secured and unsecured hedging). These need to be considered by reference to the terms of the relevant documents, but common issues are:

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

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

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

Derivatives use may impact upon a number of financial covenants:

(1) *Uncalled commitments cover*. This financial covenant measures the level of financial indebtedness incurred by the fund against the quantum of its uncalled commitments. As noted above, the manager will need to understand to what extent derivatives exposure (including any guarantee, where relevant) is included within financial indebtedness for the purpose of this covenant and how that exposure is measured.

(2) *Interest cover*. This financial covenant, often seen in NAV facilities, measures the level of finance charges that the fund must pay under its financial indebtedness against net cashflow generated by its portfolio of investments. The manager will need to determine to what extent payments and other charges on its derivatives will constitute finance charges for the purpose of assessing compliance with the covenant.

(3) *Loan to value*. This financial covenant, usually found in NAV or other "aftercare" facilities, compares the level of financial indebtedness to fund NAV. The manager will need to identify the extent to which the derivatives transactions will either need to be included in the financial indebtedness calculation or will impact upon the NAV figure for the purpose of this covenant. Impact on NAV is more likely in circumstances where the derivatives have been entered into below fund level.

(c) *Availability of subscription facility*. Derivatives transactions may impact upon the availability of a subscription facility (or other credit agreements, where the facility limit is dictated by the level of uncalled commitments). This is because the terms of the credit agreement may require that, when calculating the borrowing base, the

uncalled commitments be reduced by the amount of any derivatives liabilities (and any guarantee given in relation to derivatives transactions).

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

Issues to consider under the derivatives documentation

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

(a) *Recourse*. The manager will need to ensure that its derivatives documents reflect the correct separation of liability and recourse across its fund structure (for example, if hedging is only for liabilities relating to some investors (say a USD sleeve of a fund that mainly raises capital in EUR and invests in EUR assets) or certain fund-owned vehicles but not others (such as friends and family or carry vehicles)).

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

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

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

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

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

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

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

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

Conclusion

Looking ahead, challenges such as maintaining a level playing field, from a regulatory perspective, between the UK and EU derivatives markets and the cessation of LIBOR by the end of 2021 (which may require amendments to fund finance facilities and to derivatives documentation, noting that the lending and derivatives markets are not yet aligned regarding replacement rates and so funds may be exposed to basis risk) are likely to be of concern to managers considering entering into derivatives, whether at the fund level or otherwise. However, the enduring popularity of fund-level hedging, in particular, does not seem to show signs of abating.

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

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

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