All shapes and sizes: subscription facilities as financing tools for investment funds

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Introduction

The subscription line facility, also known as a commitments-based or capital call facility, has become a significant and useful financing tool for numerous investment funds, in particular those managed by large and middle market fund sponsors. Borrowers utilise subscription line facilities in a variety of ways ranging from short-term borrowings to bridge liquidity needs between investor capital calls (and/or to delay or avoid making frequent capital calls) to long-term leverage, which may potentially enhance the fund's internal rate of return. As the number, variety and complexity of investment funds have grown[1], subscription line facilities have adapted to the changing landscape, with sponsors and lenders working together to develop financing solutions to address the evolving needs of fund borrowers. The subscription facility market today is a robust and sophisticated one, which affords borrowers effective and efficient access to capital in an environment where funds and banks alike benefit from the significant knowledge base of its participants acquired over the years.

This article discusses the breadth of types of subscription financings currently in the marketplace by examining aspects of facilities for two specific kinds of investment funds, which can be viewed as being on opposite sides of the fund structure spectrum. We focus first on separately managed accounts in the form of a limited partnership or another entity (SMAs, sometimes also referred to as funds-of-one), and then turn to highly structured funds with large and commingled investor bases, who may invest through several separate entities within one fund family, utilising multiple tiers and/or parallel vehicles. There are, however, common characteristics underlying facilities of both kinds (as well as almost all other subscription line facilities), and so we begin our discussion by presenting some of those basic principles. Finally, we conclude by bringing the analysis into the context of certain current trends in the market, highlighting lessons from our recent experience in the fund financing space and a brief outlook for the year ahead.

Background – Understanding subscription facilities

Subscription line facilities are effectively a form of "asset-based lending", where the ability to borrow is determined principally by reference to the value of assets that the borrower (or a related entity) provides as collateral for its loan. Any such assets must

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meet certain specified eligibility criteria in order to count towards the "borrowing base" against which a bank will advance loans. While traditional asset-based lending primarily considers equipment and receivables as suitable credit support, the concept of lending against assets has taken root in the fund finance space, where investment funds are able to utilise other forms of collateral as well, including the underlying investments of a fund. In contrast to such asset-based facilities, a subscription line facility's collateral package is anchored by the commitments of the fund's investors that have not yet been funded. A subscription line facility is thus typically secured by way of a pledge of: (i) the unfunded capital commitments of the investors; (ii) the right to make capital calls from investors, and receive proceeds of such capital calls in the form of contributions; (iii) the bank accounts into which the capital contributions are funded; and (iv) certain rights related to the foregoing (including the right to enforce against such investors) and the documentation evidencing the same (including subscription agreements of the investors and organisational documents of the fund).

From an underwriting perspective, lenders scrutinise the investor base of the fund/borrower and, because the collateral for a subscription facility is intrinsically tied to the ability of the investors to make capital contributions, the legal relationship between the investors and the fund/borrower. After determining the basic composition of investors who will form the borrowing base of the subscription line facility, the parties typically discuss appropriate advance rates and applicable concentration limits. Advance rates are the basic measure of the amount of credit a lender will advance against a particular investor's commitment. While advance rates generally depend upon a relatively standard convention of investors being classified as either an "included investor" (usually institutional investors with certain rating and/or of sufficient financial strength) or a "designated investor" (other investors meeting certain criteria) and typically fall within a commonly accepted market range for each of those investor categories, there are other potential approaches negotiated in unique situations. Concentration limits present a further refinement of how the overall borrowing base credit is distributed among various classes of investors, and are generally determined based upon the makeup of a particular fund's investor base. Lenders often look to reduce risk through diversification and thus aim to calibrate the classes of investors within the borrowing base in order to achieve a level of diversity and ensure that, from their perspective, a disproportionate amount is not advanced against any investor of a particular class, either individually or in the aggregate for such class.

From a legal perspective, close attention by sponsors and lenders alike needs to be paid to the organisational documents of the fund/borrower, which (within the statutory framework applicable to the particular fund/borrower entity in question) set forth the contractual obligation of the investors to fund capital if and when called. The organisational documents are not technically part of the transaction documentation for a subscription facility, however, their relationship to the loan documentation in some respects resembles that of the merger/acquisition agreement to the loan documents in a leveraged buy-out context (e.g., care needs to be taken to ensure that the loan documentation conforms to the parameters of the organisational documents much like it would have to conform to the merger/acquisition agreement), while remaining unique in other aspects (as the organisational documents are also the primary evidence of the underlying collateral). A lender's diligence is mainly concerned with its ability to enforce its rights over the collateral package (i.e., the unfunded capital commitments and the ability to call capital), which is one of the most significant factors for determining the legal structure of a subscription line facility. Typically, lenders' counsel will need to review the formation and operating documents of the borrower (and

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any other entities that will be pledging collateral as part of the subscription line facility) and the related agreements between each investor and such entities, including the subscription documents and side letters, if any. As a starting matter, lenders are looking for provisions authorising the borrower (and, more specifically, the general partner, manager or other controlling person) to, without further consent or action by the investors, incur debt and grant liens, and in particular a pledge of the investors' capital commitments (including, if applicable in more complex structures, on a cross-collateralised basis).

Further, lenders typically require comfort in the form of language that evidences an absolute obligation for investors to fund capital contributions without setoff, counterclaim or defence (including bankruptcy) and certain other "borrowing provisions" and acknowledgments by the investors that relate to the ability of the fund/borrower (and potentially, should the fund/borrower ever default on the subscription facility, the lender) to call capital both during and after the investment period in order to repay the debt under the subscription facility. Given the importance of the organisational documents, lenders are sensitive to amendments of any provisions thereof that would impact their collateral or related rights, and so funds/borrowers are often required to, at minimum, notify the lender of such changes and/or obtain consent for such amendments that would materially and/or adversely affect a lender (and, of course, such amendments typically need to be approved by the investors themselves). Accordingly, many fund sponsors now, with assistance from counsel, have started incorporating the appropriate provisions into their organisational and offering documents at the outset of the fund (or at a later point in time when a subscription facility is being put in place). Additionally, in some cases (in particular, when organisational documents do not contain the requisite provisions), lenders may seek to also have investors enter into consent letters with lenders, which address the pertinent issues and also establish direct privity of contract between such investors and the lender. We will address certain situations in which obtaining such letters may be beneficial for structuring the subscription facility from both the borrower and lender perspective in more detail below.

Subscription line facilities for differing fund structures – Varied flexibilities

While emphasis on the collateral and the fund's organisational documents is common in all subscription line facilities, the variety of fund structures and underlying investor pools can result in differing considerations and often requires customised loan documentation for specific transactions. Below, we highlight some of the potential practicalities that sponsors, lenders and their respective counsel may encounter when dealing with subscription line facilities entered into by different types of funds in the context of SMAs (which may have only a single investor) on one hand, and complex commingled funds (which may have hundreds or more investors and utilise numerous entities that are part of one fund family) on the other hand. Depending upon the nature, size and complexity of the fund, there is a wide range of factors to be considered, and just a few examples are addressed here to illustrate this diversity.

Separately Managed Accounts (SMAs) – Addressing the single investor

As discussed above, the investor base of a fund is a determining factor for lenders in establishing the borrowing base for a subscription line facility. The credit quality of the investors and their ability to meet calls on the capital commitments are aspects that can influence the commercial terms of the facility, including margins and fees, concentration limits, exclusion events and events of default resulting from investors' failure to

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fund. When there is only a single investor, as is the case for SMAs, there are unique considerations for the related subscription line facility, including those stemming from an increased concentration risk. These considerations, however, can usually be addressed through appropriate structuring and documentation.

In our experience, SMAs continue to increase in popularity for a host of reasons, in particular among large institutional investors (such as state and private pension funds, educational endowment funds, insurance companies and sovereign wealth funds). They have become more commonplace in recent years as investors increasingly desire greater customisation of the product they are investing in (e.g., with respect to fees, leverage, investment guidelines, and reporting). In addition, learning from the lessons of the financial crisis of 2008–2009, investors are more sensitive to the risk of other investors potentially defaulting (which could have a detrimental effect on the fund's returns). There are also certain benefits to the fund sponsor in establishing SMAs for its investors, for example, the fund sponsor's administrative burden of operating an SMA is significantly less compared to operating a commingled fund of the same size. Finally, when structured as a limited partnership or similar entity, an SMA may offer an increased legal protection from liability, much like a commingled fund would.

While from a financing perspective SMAs present some specific challenges, there are also advantages, and indeed it appears that, with the increased number of SMAs in the marketplace, there has been a corresponding uptick in subscription line facilities for these investment products. Like any other fund, the terms of the organisational documents of an SMA, whether it be a limited partnership agreement or similar operating agreement, need to satisfy the general requirements of subscription lenders. As such, the operative document of an SMA should expressly authorise the general partner or manager to enter into credit facilities on behalf of the SMA and its investor, to pledge the unfunded capital commitments of such investor as collateral for the financing, and include other provisions and acknowledgments discussed above. To the extent, however, that some or all of those provisions are not included in a manner satisfactory to a lender, it may be easier for the sponsor and the investor to adjust the organisational document accordingly, since this process does not require a consent solicitation from multiple investors.

In the alternative (or in addition) to incorporating such provisions in the organisational documents, it is fairly common for lenders to request that the investor in the SMA enter into an investor consent letter with respect to representations and covenants relating to the pledge of the uncalled capital commitments in favour of the lenders, the funding of capital calls and related matters. As mentioned above, such a letter establishes a direct contractual relationship with the lenders, which gives them an increased comfort level. In addition, the investor letter may also address the less frequent cases where the operating agreement for an SMA gives certain consent rights concerning the SMA's ability to enter into financing arrangements to the investor, and the parties do not wish to formally amend the constitutional document itself. Also, because many investors in SMAs are government pension plans or sovereign wealth funds, an investor letter might address sovereign immunity issues that such investors may potentially present to lenders, in particular a concern that an investor may raise sovereign immunity as a defence to funding capital calls. One possible approach is to incorporate a waiver (which may be appropriately limited to address the relatively narrow scope of lender concerns) of sovereign immunity defences. The treatment of such issues, however, is a highly individualised analysis that needs to be performed on a case-by-case basis.

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As compared to subscription line facilities for multiple-investor funds, advance rates for the single-investor SMAs tend to be more customised and negotiated with lenders. While banks will generally lend based on the creditworthiness of each investor, and thus in theory should be able to assign an advance rate for an investor in an SMA that is substantially equivalent to the advance rate such investor would receive if it were investing in a commingled fund, there are other relevant factors that may necessitate a different approach. For example, lenders cannot rely upon a diversified investor base that, in the aggregate, reduces the exposure to an individual investor funding failure. Further, in many commingled funds' facilities, there are investors whose credit quality or other circumstances do not qualify for the inclusion of such investors in the borrowing base. Even though there is no borrowing credit for those investors' commitments, they are still pledged as collateral and so a lender might be able to offer an advance rate that ultimately recognises such "overcollateralisation". However, if the obligation to fund capital commitments rests on a single investor, and lenders are not entirely comfortable with that investor (for example, because of lack of ratings, insufficient financial information and/or known investing track record), they may price such factors into the terms of the fund's subscription line facility, offer a lower advance rate, or potentially may not be able to lend in such situations.

There may be other terms in SMA subscription line facilities that are unique and differ as compared to commingled fund subscription line facilities, including with respect to enforcement rights and exclusion events, for which lenders may seek a stricter regime in some respects. For example, certain exclusion events (i.e., events that, if they were to occur with respect to an investor, would trigger removal of such investor from the borrowing base) under a commingled fund subscription facility may be characterised as events of defaults (i.e., events that give the lender a right to accelerate the amounts outstanding under the facility and pursue remedies) under an SMA subscription facility. For some exclusion events, such treatment would stand to reason: if the single investor in an SMA defaults on its obligation to fund a capital call, because there are no other investors in the borrowing base, it makes sense conceptually that such occurrence may be an event of default under the SMA subscription facility. This is true even though if the same failure to fund capital by such investor were to occur in a commingled fund, the typical subscription facility would simply no longer allow for borrowing against such investor's commitment – and only if that investor's capital commitment was material (i.e., as a percentage of overall commitments) and/or if other significant investors (with commitments in the aggregate above agreed-upon thresholds) also defaulted, an event of default would be triggered under such a commingled fund's facility. Further, for a number of exclusion events (e.g., a breach of the representations and warranties made by investors under their subscription documents), there may be negotiated cure periods and/or other mitigating qualifiers before such occurrences result in removal from the borrowing base in a commingled fund subscription line facility, but lenders may look more stringently at these events in an SMA subscription facility.

Outside of specific concerns as to the terms and structuring of SMA subscription line facilities, sponsors with multiple SMAs may be able to utilise the straightforward nature of the single-investor vehicle in order to achieve greater efficiency with respect to the facility documentation. Indeed, some sponsors have found that SMAs are generally well-suited for employing the so-called "umbrella" technology, pursuant to which the same lender provides individual and separate loan commitments to multiple borrowers under one credit agreement. Under these instruments, many of the terms are shared by all of the SMAs that are parties to the loan document, but investor-specific terms, such as the advance rate and

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the loan amount, can be different for each SMA, and each SMA remains severally (and not jointly) liable for its own borrowings. Additionally, the distinct facilities are not cross-defaulted or cross-collateralised, so that potential issues under one SMA's facility will not impact another SMA's facility, even if they are both party to the same credit agreement. Umbrella facilities allow sponsors to negotiate just one set of documentation while putting multiple facilities in place and, while this may not be a universally applicable approach, in our experience it can be successfully utilised under the correct circumstances (e.g., for SMAs with comparable tenor).

Even if an SMA is not looking to borrow directly under a subscription line facility, there may be additional considerations if an SMA is an investor in a commingled fund that is taking advantage of a subscription line facility. As an investor in a commingled fund, one would expect an SMA will be assigned advance rates and concentration limits consistent and comparable with other institutional investors; however, in certain situations where the lenders are requiring investor consent letters, they may further request that the underlying investor in the SMA also enter into such a letter (either directly with the lenders and/or with the commingled fund/borrower). Sponsors should therefore be cognisant of such considerations when projecting their borrowing bases, and may wish to discuss sufficiently in advance the potential need for an investor consent letter, and whether the underlying investor needs to be a party to the same.

Multi-layered commingled funds – Financing solutions for complex structures

As we have seen, an SMA, with its single investor, presents some unique considerations in the context of a subscription line facility, a number of which were analysed above. At the other end of the fund spectrum, there are pooled investment fund vehicles with diverse investor bases, which may include a variety of both institutional investors, as well as private wealth management clients (e.g., high net worth individuals and their family offices) and, at times, the sponsor's management and employees. Depending on the composition of the investor base, such fund structures often require, due to various tax, regulatory and other considerations, multiple entities through which the investors can access the underlying investments, resulting in structures that can be quite complex. While fund sponsors may have different preferences in the structuring of their funds, there are some commonly used approaches in the market that we describe below.

A frequently used technology is a multi-tiered structure, sometimes referred to as the "master-feeder" structure. This arrangement utilises two or more separate entities on top of each other; investors contribute capital through a "feeder" fund, which then invests (feeds) the capital through a "master" fund, which in turn invests the capital in investments, either directly or indirectly through subsidiaries. In certain situations, there may be some investors who invest through the feeder fund, and other investors who invest directly into the master fund.

The characteristics of the master fund and the related feeder funds are driven in part by the nature of the investors and their related tax considerations. For U.S.-based sponsors, the master fund is often formed as a Delaware or Cayman Islands limited partnership that is treated as a pass-through entity for U.S. federal income tax purposes. Taxable U.S. investors generally prefer to invest in the master fund either directly or through an "onshore" feeder fund that is typically a Delaware (or sometimes Cayman Islands) limited partnership, treated as a pass-through entity for U.S. federal income tax purposes. When the investor pool includes non-U.S. investors and/or certain tax-exempt U.S. investors, one or more separate "offshore" feeder funds, which are treated as non-U.S. corporations (or, as the case may be,

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depending on a particular structure, non-U.S. limited partnerships) for U.S. federal income tax purposes, are often formed in various jurisdictions (frequently Cayman Islands, British Virgin Islands or Bermuda and increasingly, in particular for European-based investors, also other jurisdictions such as Luxembourg, Ireland and Scotland) in order to provide these investors with protection from direct U.S. federal income tax filing and payment obligations as a result of their investments in the master fund. In some circumstances, a separate fund structure may be formed for different types of investors without there being an aggregating master fund (sometimes referred to as a "parallel fund" structure).

Regardless of jurisdiction and/or legal form, all the entities in these types of structures are part of one fund family, and are managed by a common investment manager, which can be accomplished in a variety of ways, including by utilising multiple affiliated entities and/or independent managers. Each of the various vehicles is typically a separate legal entity, though the exact characteristics may depend on how the relevant legal forms of the vehicles are treated in their applicable jurisdictions and, in some cases, may statutorily be required to act through another entity (for example, a Cayman Islands limited partnership acts through its general partner). The considerations that determine the characteristics of each entity can contribute to the complexity of the structures in terms of which entities need to be party to the subscription facility documentation. Most multi-tiered funds need to ascertain at which level borrowings will be made (in other words, which entity will be the borrower under the subscription facility). This choice of borrowing entity may be affected by any number of different factors, including tax and regulatory considerations, administrative ease and operational requirements of the sponsor. To the extent that investor capital commitments are not made directly to the borrowing entity, consideration must be given as to how to mechanically ensure, through the legal documentation, that a security interest in the collateral has been properly granted for the lenders' benefit. Accordingly, the analysis of the underlying legal structures forms a key part of the lenders' diligence and often requires assistance by both lenders' and borrowers' counsel in the preparatory and documentation stages.

A "cascading pledge" structure is one potential method utilised to assure that lenders have an appropriate "path" to the ultimate source of capital commitments. In this scenario, the upper-tier feeder fund pledges the capital commitments of its investors to the lower-tier master fund, in order to secure such feeder fund's obligations to make capital contributions into the master fund. The lower-tier master fund then, in turn, pledges the capital commitments of its "investors" (i.e. the upper-tier feeder fund(s)) to the lenders to secure such master fund's obligations as a borrower under the subscription line facility. This can be a beneficial arrangement from both a borrower and a lender perspective, in particular in situations where, for example, due to regulatory reasons, the feeder fund may not be permitted to be in direct privity with the lenders. From a documentation perspective, this structure typically includes a separate security agreement between the master fund on the one hand and the lender on the other hand, and a separate "back-to-back" security agreement between the feeder fund on the one hand and the master fund on the other hand.

Other possible alternatives include an arrangement where (if permissible) the feeder fund may become a party to the subscription line facility agreement and/or security agreement with the lender. Under this approach, the feeder fund may become a co-borrower of the loans, become a guarantor of the indebtedness incurred by the master fund, or just provide a "naked" pledge of the investors' capital commitments directly to the lender. In short, with proper assistance from counsel, there are many options available to sponsors and lenders which can address virtually all relevant structuring considerations.

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Because of the highly structured nature of complex commingled funds featuring multiple tiers and/or parallel "silos", there are sometimes circumstances where additional work is required in order for the sponsor to be able to take as full advantage as possible of all the investor capital commitments available to the fund family. For example, due to tax, regulatory or other considerations, it may not be possible to have the parallel entities jointly and severally liable for repayment of the loans and, in some instances, the "onshore" and "offshore" entities may be required to enter into separate credit agreements. Such separate credit agreements may or may not be permitted to be cross-collateralised, whether for tax and/or regulatory reasons or because of an understanding with the investors in the separate vehicles. This effectively means that each of the parallel vehicles must rely on a borrowing base comprising only capital commitments of its own (either "onshore" or "offshore") investors.

As discussed above, the investor composition will likely vary as between such vehicles and, because banks will typically provide different advance rates and concentration limits based on their underwriting criteria, the borrowing capacity of one silo may be different from the borrowing capacity of the other silo(s). Since sponsors ordinarily aim to manage borrowings on a consistent level across the various vehicles in a fund family, the ability to borrow might then be dictated by the vehicle with the lowest borrowing capacity. One potential solution may be to, where permissible, provide for a cross-guarantee and/or cross-default between the individual credit agreements, which might allow the borrowing base to be calculated on an aggregate basis. Another possible alternative is the use of investor consent letters, where a lender, in exchange for greater credit and legal comfort based on direct privity with the investor, may be able to, among other things, relax concentration limits that it would have otherwise imposed on investors, thereby allowing for a more generous separate borrowing base in the silo(s) where it is most needed.

As illustrated here, multi-layered, commingled funds differ significantly from SMAs in many respects, including the level of structuring, investor composition and management. These differences often inform the specific legal and underwriting considerations that should be addressed when entering into a subscription line facility for such divergent funds. The fact that sponsors and lenders have developed the concepts and documentation necessary for subscription facilities for these disparate types of funds evidences the growth and increased sophistication of the subscription financing industry.

Conclusion and outlook

The finance group at Fried Frank has seen a continued and steady increase in the volume and number of fund financing transactions (and subscription line facilities in particular) over the past several years. We believe that the popularity of this product is driven in part by the strong performance that these loans have demonstrated over extended periods of time, including through the economic downturn. In our practice, we have not become aware of an event of default under any of the subscription facilities where we have acted as counsel.[2] In light of this stability, and the continued ability of sponsors and lenders to craft solutions that meet the growing needs and complexities of funds being developed, we anticipate that the popularity of subscription line facilities will continue to remain strong. Moreover, we expect to see convergence of the larger fund financing market – where we see increasing appetite for a combination of subscription and asset-based facilities, whether in the form of hybrids (with a collateral package that consists of both uncalled capital commitments and underlying investment assets) or other bespoke instruments (for example, where a traditional subscription-based borrowing base is enhanced by a component based on value

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of the underlying investment assets, but without a corresponding pledge).

At the same time, we believe there are certain aspects of subscription lending that will continue to attract attention of lenders and sponsors alike. For example, the interplay between excuse rights (i.e., situations where investors in a fund may be excused or excluded from funding a capital call for certain reasons permitted under the relevant fund documentation) and treatment of such investor's commitment under the fund's subscription line facility is coming under increased scrutiny even though investors are generally always obligated to fund capital calls for purposes of repaying the subscription facility. Another area which presents challenges, simply from a transaction process and timing perspective, is the increased frequency and scope of side letters (i.e., individualised arrangements with particular investors that alter terms of the basic organisational documents which otherwise would be the same for all investors) that investors are entering into with funds. In addition, as alternative investment vehicles (i.e., "side-car" vehicles through which funds may seek to make certain investments for specific regulatory, tax or investor preference reasons) gain popularity, the treatment of how capital commitments are allocated to such vehicles is coming into focus.

In short, while many issues have been addressed, there are and always will be new developments. Negotiations between borrowers and lenders will continue to result in innovative solutions that balance the competing interests and shared goals of the parties. This article, through its analysis of subscription facilities for SMAs and complex commingled funds, is not intended to be exhaustive and address every structuring alternative (which would be practically impossible), but to simply illustrate that the industry has been able to respond and find solutions to many of these challenges, and continues to search for ways to deliver the capital call facility product to all those who have an interest in it, and as efficiently as possible.

We are happy to note that the subscription facility market appears to remain very active even as it takes in recent political developments both in the U.S. and globally. While the uncertainty caused by Brexit and a new administration in the U.S. has put its imprint on global capital markets in many ways, such as affecting the bond market, the U.S. loan market, including the fund financing space, has largely been stable. Anecdotally, our firm continues work on numerous subscription facilities which commenced last year and are proceeding towards execution without any significant delays or complications, and is being instructed on multiple others that are just starting. We remain cautiously optimistic about the future outlook for the industry, while we wait to see how the national and international political and economic situation plays out in the longer term.

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Endnotes

1. The recent report published by Preqin and presented at the 2nd European Fund Finance Symposium in October 2016, titled 'Private Equity in Europe', highlights ten different fund types that investors view as presenting the best opportunities in the current financial climate, namely, Small to Mid-Market Buyout, Venture Capital, Distressed Private Equity, Growth, Fund of Funds, Secondaries Funds, Natural Resources, Mezzanine Funds, Large to Mega Buyout and Cleantech.
2. The participants and panelists at the recent European Fund Financing Symposium held in London in October 2016, and Global Fund Financing Symposium held in New York in March 2016, did not report any transaction defaults or institutional investor exclusion events that resulted in losses. However, some technical defaults have been reported. We have experienced instances of such technical defaults in our practice as well, but as far as we are aware, they have been remedied to the relevant parties' satisfaction in all cases.

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