Not your garden variety: Subscription facilities around the world

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The subscription facility has become a significant, useful and global financing tool for investment funds seeking effective and efficient access to capital. Borrowers utilise subscription facilities in a variety of ways, ranging from short-term borrowings (that are used primarily to bridge liquidity needs between investor capital calls and/or to avoid making frequent capital calls) to long-term leverage (which may potentially influence fund investors' return profile).

The subscription facility, which has its roots in the US real estate space, is now used by funds with different investment strategies across the full range of asset classes and around the globe, most notably in the European market (in particular the UK) and Asia. As the number, variety and complexity of investment funds have grown, subscription facilities have adapted to the changing landscape, with fund sponsors and lenders collaborating to develop financing solutions designed to address the evolving needs of fund borrowers and their investors. The subscription facility market today is robust and sophisticated, and its popularity and complexity continues to rise as new players, both on the borrower and lender side, enter the space with specific demands, resulting in the need for customization in virtually every case.

For example, while an uncommitted "accordion" (a feature which allows a borrower to increase the size of an initial facility, subject to lender consent and credit approval) has historically been a frequent component of subscription facilities, we now see a rising number of facilities that are not legally committed at all (or that contain committed and uncommitted "tranches", both of which are available from the outset). This article looks at the breadth of the types of subscription financings currently in the marketplace by examining select aspects of facilities for various kinds of investment funds in the US and UK markets.

Background – Understanding subscription facilities

While a "cookie cutter" subscription facility is a myth, these facilities do share some common traits which are helpful to understand – and so we begin with the basics. Subscription facilities are effectively a form of "asset-based lending", where the ability to borrow is determined principally by reference to the value of certain eligible assets that the borrower (or a related entity) provides as collateral for its loan and which count towards the "borrowing base" against which a bank will advance loans. A subscription facility's collateral package

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is anchored by the commitments of the fund's investors that have not yet been funded. The facility is typically secured by: (i) the unfunded capital commitments of the fund's 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), as well as the documentation evidencing such rights (including subscription agreements of the investors and organizational documents of the fund).

Because the collateral for a subscription facility is intrinsically tied to the obligation of the investors to make capital contributions, lenders closely scrutinise the investor base of the fund and the legal relationship between the investors and the fund. After determining the basic composition of investors that will be included in the borrowing base of the subscription facility, the parties negotiate 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. In general, advance rates depend upon a relatively standard convention of each investor 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). The advance rate typically falls within a commonly accepted market range for each of the preceding investor categories. However, there are other potential approaches to categorizing investors – for example, a segment of the US market functions on the basis of a "simplified" borrowing base with a "flat" advance rate against an aggregate investor pool, which generally encompasses all of a fund's investors.

We also increasingly see further bifurcation of advance rates, either for certain categories of investors or for specific investors, depending on additional supporting criteria. For example, there may be a higher advance rate afforded from the moment in time at which capital commitments over a certain threshold have already been funded; this feature caters to the natural cycle of an investment fund because as capital is drawn, the amount of credit support available for a subscription facility decreases. However, a higher advance rate may alleviate or even equalize these consequences – and, from a lender's perspective, the diminished uncalled capital is counterbalanced by an increase in the invested assets of the fund and by the investors having more "skin in the game").

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 pool. 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 certain level of diversity and ensure that, from their perspective, no disproportionate amount is advanced against the uncalled capital commitment of 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 organizational documents of the fund, which (within the statutory framework applicable to the particular fund entity in question) set forth the contractual obligation of the investors to fund capital if and when called. 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 facility. Typically, lenders' counsel will need to review the formation and operating documents of the borrower (and any other entities that will be pledging collateral as part of the subscription facility) and the related agreements between each investor and such entities, including the subscription documents and side letters, if any.

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As a starting matter, lenders are looking for provisions authorizing the borrower (or its general partner, manager or other controlling person) to, without further consent or action by the investors, incur debt and grant liens, including granting a pledge of the investors' capital commitments (which may be, if applicable in more complex structures, on a cross-collateralized basis). Further, lenders typically require language that evidences an absolute obligation for investors to fund capital contributions without setoff, counterclaim or defence (including bankruptcy). Additional comfort is often provided in the form of certain other "borrowing provisions" and acknowledgments by the investors that relate to the ability of the borrower (and, should the borrower ever default on the subscription facility, the lender) to call capital both during and after the investment period in order to repay the borrower's debt under the subscription facility.

Accordingly, most fund sponsors now incorporate corresponding provisions into their organizational and offering documents. Given their importance, lenders are sensitive to amendments of organizational documents that would impact their collateral or related rights, and so borrowers are often required to notify the lender of such changes and, in some instances, obtain consent for certain amendments. Additionally, in some cases, lenders may seek to have investors enter into consent letters, which address the pertinent issues and establish direct privity of contract between such investors and the lenders. 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 facilities for differing fund structures – Varied flexibilities

The variety of fund structures and underlying investor pools can result in differing considerations and typically requires custom and complex loan documentation for specific subscription facilities. In particular, fund structures cater to the differing needs of, and provide suitable investment platforms for, a diversified investor base, for example by increasingly utilising levered and unlevered sleeves and multiple jurisdictions as entry points. Below, we illustrate the need for bespoke structures, highlighting some of the potential practicalities that sponsors, lenders and their respective counsel may encounter when dealing with subscription facilities entered into by different types of funds in the context of: (i) so-called SMAs (which may have only a single investor); (ii) complex commingled vehicles (which may have hundreds or more investors and utilise numerous entities that are part of one fund family); and (iii) by comparison, funds in the UK market.

Separately Managed Accounts (SMAs) – Addressing the single investor

As discussed above, the investor composition of a fund is a key factor for lenders in establishing the borrowing base for a subscription facility. Each investor's credit quality, along with their ability to meet capital calls, are both factors that can influence the commercial terms of the facility, including margins, fees, advance rates, concentration limits, events of default and exclusion events. When there is only one investor, as is the case for SMAs, unique considerations for the related subscription facility arise, including those stemming from an increased concentration risk.

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. For example, investors increasingly desire greater customization of the product they are investing in (e.g., with respect to fees, leverage, investment guidelines and reporting). Additionally, in the wake of the 2008–2009 financial crisis, investors are more sensitive to the risk of default by other

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investors, because such defaults could have a detrimental effect on the fund's returns. There are also certain benefits to the fund sponsor, such as a lighter administrative burden in operating the SMA fund, as compared to operating a similarly sized, commingled fund.

While from a financing perspective SMAs present some specific challenges, there are also advantages and, indeed, it appears that as the number of SMAs in the marketplace has increased, so too have subscription facilities for these investment products. Like any other fund, the terms of the organizational documents of an SMA must satisfy the general requirements of the subscription facility lender. To the extent, however, that some or all of those provisions are not drafted in a manner satisfactory to a lender, it may be easier for a sponsor and investor of an SMA to revise the provision than it would be for those in a multi-investor fund, because the revision process for the latter requires a consent solicitation from multiple investors.

As an alternative (or an addition) to incorporating such provisions in the organizational documents, it is fairly common for lenders to request that the investor in the SMA enter into an investor consent letter to address any other specific issues which may arise in a particular context (for example, as many investors in SMAs are government pension plans or sovereign wealth funds, there may be sovereign immunity issues that such investors might potentially present to lenders). Understandably, the treatment of such issues requires a highly individualized analysis to be performed on a case-by-case basis.

As compared to subscription facilities for multiple-investor funds, advance rates for the single-investor SMAs tend to be more customized and negotiable. While banks generally lend based on the creditworthiness of each investor, and thus would be expected 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, other factors may necessitate a different approach. For example, in an SMA scenario, lenders cannot rely upon a diversified investor base that, in the aggregate, reduces the exposure to an individual investor's funding failure.

Further, in many commingled funds' facilities, there are investors whose credit quality does not qualify them for inclusion in the borrowing base. Even though there is no borrowing base credit given for those investors' commitments, they are still pledged as collateral and so effectively provide for further "overcollateralization". However, if the obligation to fund capital commitments rests on a single investor whom lenders are not entirely comfortable with (for example, because of lack of ratings, insufficient financial information and/or a lack of investment track record), lenders may price such factors into the terms of the fund's subscription facility, offer a lower advance rate or may be unable to lend altogether.

There may be other terms in SMA subscription facilities for which lenders may seek a stricter regime, as compared to commingled fund subscription facilities. For example, certain exclusion events (i.e., events that, were they 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. There is sound economic rationale for this approach for a number of exclusion events: for instance, if the only investor in an SMA defaults on its obligation to fund a capital call, the lack of any other investor commitments to fall back on makes it reasonable to characterise such an occurrence as an event of default.

However, if the same failure to fund capital were to occur in a commingled fund, the typical subscription facility would simply no longer give credit for such investor's commitment in

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the borrowing base. Only if investors with material capital commitments (above agreed-upon thresholds) defaulted, would an event of default be triggered under 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 facility. However, lenders may look more stringently at these events in an SMA subscription facility.

Focusing on potential advantages, 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 facility documentation. Indeed, some sponsors have found that SMAs are generally well-suited for employing so-called "umbrella" technology, pursuant to which the same lender provides individual and separate loan commitments to multiple borrowers pursuant to one credit agreement. Under these instruments, many of the terms are shared by all of the SMAs party to the loan document, but investor-specific terms, such as the advance rate and 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-collateralized, meaning potential issues under one SMA's facility will not impact another SMA's facility, even if both are party to the same credit agreement. Umbrella facilities allow sponsors to negotiate a single set of documentation while putting multiple facilities in place. While this may not be a universally applicable approach, in our experience it can be successfully utilised under appropriate circumstances (e.g., for SMAs with comparable tenor).

Multi-layered commingled funds – Financing solutions for complex structures

At the other end of the fund spectrum, there are pooled investment fund vehicles with diverse investor bases, which may include a variety of institutional investors, as well as private wealth management clients (such as 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 funds 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 passes on (feeds) the capital to a "master" fund, which in turn makes 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 US-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 US federal income tax purposes. Taxable US 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 US federal income tax purposes. When the investor pool includes non-US investors and/or certain tax-exempt US investors, one or more separate "offshore" feeder funds, which are treated as non-US corporations (or, as the case may be,

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depending on a particular structure, non-US limited partnerships) for US federal income tax purposes, are often formed in various jurisdictions (frequently Cayman Islands, British Virgin Islands or Bermuda and increasingly, and in particular for Europe-based investors, also other jurisdictions such as Luxembourg, Ireland and Scotland) in order to provide these investors with protection from direct US federal income tax filing and payment obligations as a result of their investments in the master fund.

As tax and regulatory regimes around the world develop, it appears that the number of funds employing multiple non-US jurisdictions within the same fund family is on the rise. 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 granted, directly or indirectly, 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)), and any rights it may have under the pledge granted to it by the upper-tier feeder fund, to the lenders to secure such master fund's obligations as a borrower under the subscription 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 facility agreement and/or security agreement with the lender. Under this approach, the feeder fund may become a co-borrower of the loans,

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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.

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-collateralized, 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 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, whereby a lender may be able to 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.

European perspective – Looking across the pond

The internationalization of the subscription finance market, on the buy-side as well as the sell-side, has influenced the documentation and transaction terms of subscription facilities in the European market. The European market has seen a steady inflow of US-based sponsors expanding their investment activities across the Atlantic and seeking subscription facilities similar to those they are accustomed to in the US. This phenomenon is likely to have contributed to the increase in European and US-based lenders offering subscription facility terms in the European market similar to those seen in the US market. Nevertheless, despite a trend for convergence of the terms of subscription facility documentation in the two markets, certain differences persist due to differing approaches to credit evaluation, and local law requirements with respect to the creation and perfection of security interests in collateral.

Subscription facilities in the UK market were historically almost exclusively the product of "relationship" deals, with lenders primarily focusing on the success record of the larger sponsor group when determining whether to offer a subscription facility to an individual fund. While there certainly are (often important) relationship aspects that come into play in US transactions as well, the modern US subscription facility is highly focused on the creditworthiness of individual investors in a fund.

This difference in approach was reflected in some of the terms typical of subscription facilities in the UK market. For example, traditionally subscription facilities in the UK market frequently used the "coverage ratio" to limit the amount that may be drawn under

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the facility at any given time. The coverage ratio is the ratio of the uncalled capital commitments of the included investors to the aggregate indebtedness of the fund, and is typically set at no less than 1:1. Notably, the coverage ratio approach does not typically involve applying advance rates to the uncalled capital commitments of included investors, meaning that once an investor is deemed an "included investor", the borrower receives credit for 100% of that investor's uncalled capital commitment.

US subscription facilities typically use a borrowing base calculation to limit the amount that may be drawn under the facility at any given time, and lenders will only advance a certain percentage of the uncalled capital. The advance rate allocated to individual investors as part of this US approach typically depends on the creditworthiness of those investors and, while these rates often fall within a range that is considered "market" for the investor being assessed, they are determined by a lender on the basis of its own credit analysis, undertaken in respect of the investor on a case-by-case basis (however, as noted above, a "flat" advance rate isn't uncommon either in a segment of the market).

Increasingly, and as an example of the convergence of facility terms in respect of facilities in the UK market with those used in facilities in the US market, the US model of a borrowing base methodology is becoming more common. Parallel to the development of the borrowing base methodology, investor exclusion events have also been refined. These events are typically narrower in scope for facilities that apply a borrowing base methodology, but since they are often tailored to particular investors, they can be greater in the number of events they seek to address. On the other hand, other trends in the US market are less often seen in the UK market, for example, investor letters are rarely required.

Whilst the internationalization of the subscription finance market is in certain instances leading to a convergence of terms of subscription facilities in US and European markets, there are certain aspects of subscription facilities that remain specific to the jurisdiction applicable to the relevant fund, particularly with respect to the granting and perfection of security interests. For many transactions, granting and perfecting security interests over the uncalled capital commitments of the funds' investors, the rights of the general partner to call capital commitments and the bank accounts into which any capital commitments called from investors are funded, present key elements under the relevant subscription facilities, and often form the principal collateral base of the subscription facilities secured in favour of the lenders.

The creation and perfection of security interests in subscription facility collateral differs by jurisdiction. Briefly, in the US, security interests over the rights to call uncalled capital commitments are created when the lender is given value by the borrower, the grantor has rights over the collateral, and the grantor pledges that collateral by entering into a signed security agreement sufficiently describing the collateral. At this point, the security interest is created and "attached", and the lender may enforce the security interest against the borrower per the terms of the transaction. In order to perfect the security interest and enforce the lender's rights against third parties, the parties must file a UCC-1 financing statement, typically on or shortly after creation of the underlying security interest. Thus, for perfection, it is customary for the security agreement to contain an authorization by the borrower for the filing of such financing statements (and, without appropriate provisions, a filing by the lender might not be authorized).

By comparison, under English law, for example, the security interest of lenders in the rights of the general partner to call capital from the limited partners is typically created pursuant to an assignment by way of security. The perfection of such security interest occurs upon

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the delivery of a notice to the investors in the fund, informing them that the general partner has entered into a subscription facility on behalf of the partnership and assigned its right to call capital under the partnership agreement to the lender. To manage and protect the relationship with their investors, borrowers often seek to negotiate the timing for the delivery of the notices to investors, and are also highly sensitive to the form of any such notifications.

The increasing complexity of fund structures and jurisdictions involved, which serves to attract an increasingly global investor base, frequently requires parties to consider local law requirements in multiple jurisdictions in connection with the granting and perfection of security interest required by the credit providers. Potential conflict-of-laws issues need to be considered, as no single method of granting security and perfection under one law may be effective for the purposes of another jurisdiction.

Conclusion

As in years past, we continue to see a sustained and steady increase in the volume and number of subscription facilities, and more broadly, of fund financing transactions overall.

We believe that the popularity of this product is driven in part by the strong performance these loans have demonstrated over extended periods of time, including through the economic downturn. While we are aware of one recent reported fund default, which led its subscription facility creditors to consider enforcement options for the repayment of borrowings under the facility, it is, so far, an exceptional event that has not impacted the supply and demand dynamics of this market. In light of this stability, as well as the continued ability of sponsors and lenders to craft solutions that meet the growing needs and complexities of investment funds as they develop, we anticipate that the popularity of subscription facilities will continue to remain strong.

Moreover, we expect to see a convergence of the larger fund financing market where we are observing an increasing appetite for a combination of subscription facilities and so-called asset-based facilities (collateralized by the underlying fund investments), 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 of the underlying investment assets, but without a corresponding pledge).

As mentioned above, in our experience the various investment fund structures are usually tailored to the needs of a specific client, and as a result cannot be easily reproduced or replicated for a larger client base – and neither can subscription facilities, which must inherently carefully consider the specifics of the underlying fund. This article is not intended to be exhaustive and address every structuring alternative (which would be practically impossible), but rather to illustrate that the industry has been able to respond and find solutions to many of the challenges that it has faced over the years, and continues to search for ways to deliver the subscription facility solutions to all those who have an interest in them, as efficiently as possible.

We are pleased to note that this segment of the market appears to remain very active even as it has absorbed recent geopolitical and other developments. Indeed, the fund financing space has largely remained stable during the uncertainty caused by Brexit (as of the time of writing this article, many critical questions surrounding the future of UK-EU relations remain unresolved) and by the shift in US economic policies following the 2016 elections (such as adoption of new tax laws, implementation of trade tariffs and introduction of interest rate hikes).

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Further, an ever-changing regulatory environment can be expected to continue influencing the legal landscape with increased focus on globally relevant issues such as cybersecurity, data privacy and international sanctions. However, even if the global economy may face future headwinds, we remain optimistic about the outlook for the industry, which has weathered many challenges so far.

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