# USA

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## 2018 in review – Records, reversals and reflections

The volatility of the US markets in 2018 marked a departure from one of the longest runs of relatively steady economic growth in the recent past. While public market indicators swung wildly (even from day to day) and equities temporarily rose to record highs (the S&P 500 index briefly surpassed the 2,900 mark and the Dow Jones Industrial index reached over 26,000 points), the year ended with a negative return for virtually all asset classes, except loans (which eked out a gain of under ½%).

Numerous economic policy developments significantly impacted the markets, including four Federal Reserve interest rate hikes and several rounds of significant increases in trade tariffs. Developments in the political arena also weighed on the markets, with continued uncertainty regarding the future and form of Brexit, mid-term elections which resulted in a change of control in the House of Representatives, and three government shutdowns (itself a record). Notwithstanding the somewhat stormy seas, private capital fundraising remained strong as investors continued to pursue yields and trophy assets in an environment of high valuations and rising borrowing costs. In line with robust private fundraising, fund finance enjoyed continued growth, with some market participants believing that new records were achieved with respect to the aggregate value of financings.

This article will address recent trends in the private capital markets, including in the fund finance industry, as well as the continued public discourse surrounding subscription line credit facilities which saw a surge in 2017. It will then address other notable market and legal developments for fund financings and will conclude with a brief outlook for the year ahead.

## State of the market in 2018

Record levels of dry powder – Fewer but larger funds

2018 was preceded by what were arguably the most successful fundraising years for private capital markets worldwide.[1] Between 2013 and 2016, aggregate fundraising increased by approximately $50 billion each year, and in 2017, fundraising for the private capital markets totaled $754 billion, surpassing the previous high of $728 billion from 2016. The first three quarters of 2018 were among the slowest that private equity fundraising has seen since 2013; by mid-year, some industry reporters were predicting that fewer than 700 new funds would close by the end of the year, which would have been the first time in more than six years that so few new funds were raised. Despite its choppy start, however, 2018 has ultimately boasted impressive results and positive trends – among them being historic levels of dry powder and increased use of subscription lines.


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By December 2018, the amount of dry powder held by alternative investment funds soared to a record high of $1.8 trillion, over half of which was held by private equity funds. Further, as of October 2018, the number of private equity funds in the market reached a new record of 3,921, of which 37% chose to target investments primarily in North America. This is no surprise given that private equity returns in the US have, since 2000, outperformed various equity and bond benchmarks such as the S&P 500 (which returned a negative 9% in 2018).

It is worth noting that, as of the beginning of the fourth quarter, 44% of all funds in the market (the largest portion) targeted investments in Asia, and that six of the ten largest funds in the market were focused on investment in Asia, the largest being the China Structural Reform Fund, which sought to raise $53 billion. Although fewer in number, these funds were larger and collectively, they raised $82 billion – a $4.5 billion increase from last year. The biggest fund in North America to close in the first nine months of 2018 was the Carlyle Group's seventh flagship fund, which raised $18.5 billion.

Private equity meets venture capital

In addition, companies with venture capital funding accounted for 3.7% of private equity buyouts by mid-2018, and $8.5 billion worth of transactions in the second quarter alone involved private equity investors in the venture capital market. These developments showcase a new willingness by private equity firms to invest in early-stage companies, which historically have not been their investment target. By the third quarter, 1,592 venture capital financings took place in North America, the highest number since early 2015, representing 41% of the global total.

Fund finance

As we have noted before, predictably, the market for subscription line facilities and other financing products that leverage private capital funds is closely linked to the fundraising and successful closings of those funds. As such, the fund finance space has benefited from the growth trend of both. In parallel, the proportion of private capital funds utilising subscription line facilities as part of their capital structure has also increased in the recent past.

Although there are no published reports on the aggregate amount of lender commitments under subscription line facilities, anecdotal evidence from market participants indicates that 2018 was another successful year for the fund finance space, with some estimating several hundred billion dollars of committed facilities. And, consistent with previous years, no significant defaults under subscription line facilities were reported by lenders or their counsel in the US. (We are aware of one foreign fund experiencing a default, which led its subscription facility creditors to consider enforcement options for the repayment of borrowings under the facility, but that is so far an exceptional event.) These factors further support the proposition that in the US, subscription line facilities and other fund-level financing products play a key function in the capital structure for private capital funds.

In fact, we have seen that in recent years, sponsors are increasingly adjusting limited partnership agreement terms to account for use of fund leverage beyond the traditional "borrower provisions", including in light of the broader discussion surrounding subscription facility usage discussed below. For example, more sponsors are charging management fees on borrowing amounts during a fund's stepdown period (i.e., after the end of the investment period but before the dissolution of the fund), instead of charging management fees on capital contributions used to fund investments. Some sponsors charge on all borrowings incurred on behalf of a limited partner, while others limit the fee to borrowings under a subscription facility. This development has led some limited partners to request that amounts outstanding


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under subscription facilities be taken into account when calculating a fund's preferred return. Most major fund sponsors calculate the preferred return on a limited partner's capital contributions, which does not include any amounts drawn under a subscription facility.

**Market developments: Increasing complexity and variety**

The US subscription facility market in 2018 continued diversifying, as the popularity of the product remained on a rise, the complexity of investment fund structures evolved, and new players (both on the borrower and lender side, particularly in the middle market space and regional banks) entered the space or expanded their presence. The combination of the variety of investor demands, fund offerings that produce fund structures increasingly tailored for different investors and asset classes, and an evolving regulatory environment resulted in a customisation of subscription line facilities in virtually every case. Indeed, the notion of a "cookie-cutter" subscription line facility is a myth, perhaps even more so than it has ever been. While not exhaustive, we discuss below a few recent trends that we observed in the market.

Uncommitted facilities

Based on our experience, the number of uncommitted facilities continues to grow, as they may present fund borrowers with less expensive alternatives for financings and may provide relief to lenders in connection with capital reserve requirements. 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). While these facilities lack the legal certainty of funding, we are not aware of an experience where a borrowing was requested but the lender refused to provide the advance, which may be indicative of the strong financing market in 2018.

Diversification of borrowing base components

The amount of credit a lender will advance against a particular investor's commitment is determined by a combination of advance rates and concentration limits. In general, much of the subscription line market depends upon a relatively standard convention of investor classifications (either as "included", which is usually reserved for institutional investors with certain rating and/or of sufficient financial strength, or "designated", which is generally used for other investors meeting certain criteria), with each category falling within a commonly accepted market range for both advance rates and concentration limits. However, there are other potential approaches – 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 specification and bifurcation of borrowing base components, either for certain categories of investors or for specific investors, depending on additional supporting criteria.

For example, there may be a higher advance rate and/or concentration limit afforded after certain percentages of aggregate capital commitments have 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 or concentration limit may alleviate or even equalise 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" and thus, greater incentive to fund future capital calls.


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Fund and facility structuring

To provide suitable investment platforms for their investor base and satisfy demand for varying risk profiles, investment funds increasingly utilise levered and unlevered sleeves within one fund family that invests in the same assets (such that the levered sleeve's economic results may be amplified, both positively and negatively, and result in different returns when compared to those of the unlevered sleeve). Additionally, in response to the many tax and regulatory developments worldwide, which affect US and non-US investors alike, it has become more common to ultilise multiple jurisdictions and legal entity forms as both entry points for investors to come into the fund, as well as vehicles through which investments are made. In particular, we have seen US sponsors increasingly incorporate various European (Luxembourg, Ireland and other) structures within their funds, seeking to attract investors from the "old continent". Often, this results in additional local law documentation.

## Market developments: The public discussion of subscription line facilities

2018 saw continued discussion of the role of subscription line facilities amongst market participants, though at a lower volume and frequency than the previous year. In 2017, there was robust conversation concerning the role of subscription line facilities and investors' experience with levered closed-end funds as compared to unlevered funds. Most notably, in June 2017, the Institutional Limited Partners Association ("ILPA"), a trade organisation representing the interests of institutional investors in private equity funds, released "*Subscription Lines of Credit and Alignment of Interests: Consideration and Best Practices for Limited and General Partners*" (the "ILPA Guidelines").

The ILPA Guidelines discussed the potential lack of alignment of interests between a fund and its investors with respect to subscription line credit facilities and where, in ILPA's view, the differing interests may be detrimental to investors. In particular, the ILPA Guidelines identified that subscription line credit facilities may present investors with challenges relating to: (i) visibility of their total exposure that may be attributable to subscription line financings; (ii) judging a fund's performance based upon internal rate of return ("IRR") in the first few years when it is a subscription line facility that may not be representative of the IRR over its life; and (iii) the possibility that the fund's general partner may potentially collect carried interest earlier in a leveraged fund than it would in an unleveraged fund with the same investment strategy. The ILPA Guidelines recommended certain changes to funds and their subscription line financing providers, including increased disclosure to investors concerning a fund's use of leverage and reporting certain metrics, both on the actual basis for a levered fund and on a hypothetical basis for an unlevered fund, as well as specific leverage and other thresholds for subscription line facilities.

The ILPA Guidelines engendered significant responses from numerous industry participants, including the Fund Finance Association ("FFA"), law firms, fund managers, fund advisory firms, accounting firms, international newspapers and media companies and trade publications. Some supported ILPA's position, while many others indicated that it should be refined in a number of ways. The FFA's response, "*FFA Analysis and Recommendations on the ILPA Guidelines for Subscription Credit Facilities*", addressed the ILPA Guidelines' recommendations point-by-point. The FFA emphasised above all that any recommendations with respect to subscription line facilities should account for the wide variety of funds that use them and the diverse ways in which fund sponsors employ them to benefit their funds and investors.


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In 2018, there was continued conversation about subscription line facilities. No institutional investors or trade groups published significant critiques of subscription line facilities as far as we are aware. However, ILPA representatives held discussions with industry participants and appeared on panels at industry events, including the FFA Global Fund Finance Symposium, together with representatives from lenders, investors and law firms.

One of the messages that ILPA representatives communicated was that the ILPA Guidelines are not universally applicable to all subscription line facilities and that the recommendations in the ILPA Guidelines are most relevant for facilities that are intended to manage cash flows and avoid multiple investor capital calls. In our experience, fund sponsors continue to communicate and negotiate with their limited partners concerning leverage limitations for funds and investor reporting. Given the continued popularity of subscription facilities, we expect the conversation about these facilities to continue into 2019, as industry participants further customise them on a case-by-case basis.

**Market developments: Alternatives to LIBOR**

On July 27, 2017, Andrew Bailey, the chief executive of the United Kingdom's Financial Conduct Authority (the "FCA"), delivered a speech at Bloomberg London on the future of the London Interbank Offered Rate ("LIBOR"). As a response to the LIBOR manipulation scandals, the FCA has been regulating the administration of LIBOR since 2013. Bailey noted that the FCA has discussed with the banks which submit contributions to LIBOR (the "Panel Banks") a plan to sustain LIBOR quotations until the end of 2021, but that it does not intend to maintain LIBOR through its influence or legal powers thereafter. The FCA called for the planning and the transition to alternative reference rates (collectively, the "Successor Rate") to begin now.

Search for the Successor Rate

LIBOR represents the cost of unsecured funding in a specified currency and specified term in the London interbank market. Specifically, the Panel Banks submit to the ICE Benchmark Administration Limited (the "IBA"), the current administrator of LIBOR, the rate at which they could borrow funds by asking for, and then accepting, interbank offers in a reasonable market size. However, because such unsecured interbank lending is no longer sufficiently active, the determination of LIBOR often involves the Panel Banks' judgment.

As early as 2014, the Federal Reserve of the U.S. convened an Alternative Reference Rates Committee (the "AARC") with the express mandate of identifying a Successor Rate that is more firmly based on transactions. Currently, the AARC has close to 30 global and national financial institutions as members, and the relevant government bodies including the Federal Reserve, the US Securities and Exchange Commission and the US Treasury Department as *ex officio* members. On June 22, 2017, the AARC recommended the Secured Overnight Financing Rate ("SOFR") as an alternative to LIBOR in the US. SOFR represents the cost of overnight cash borrowings collateralised by Treasury securities and is underpinned by nearly $800 billion of daily transactions. SOFR is published daily on the Federal Bank of New York's website at approximately 8:00am, eastern time.

Transitioning to the Successor Rate

In the legal space, the transition away from LIBOR will require the creation and acceptance of market contractual terms. In October 2018, the AARC held a public comment process (the "Consultation") for interest rate replacement provisions in syndicated loan contracts that could be adopted on a voluntary basis going forward.


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The Consultation proposes two approaches: an "amendment approach" and a "hardwired approach". On or after any "trigger event", the amendment approach provides for an amendment process for the parties to select the Successor Rate, while the hardwired approach provides for a "waterfall" of alternative benchmark rates that should be selected as the Successor Rate (after which the amendment process must be used). Under both approaches, if no Successor Rate is selected, then the loans accrue interest at base rate.

So far, any approach in financing documents that attempts to provide for a Successor Rate has been handicapped by the fact that no industry-standard replacement had been identified and there being no assurance that the Successor Rate, when broadly accepted, would approximate LIBOR to the extent that the agreed-upon interest rates in the document should remain in place. The AARC has chosen the SOFR as its recommended Successor Rate, but as its Consultation notes, there are two fundamental differences between LIBOR and SOFR: (i) LIBOR has relatively long, forward-looking terms, including one-month, three-month, six-month and twelve-month terms, while SOFR is currently only available as an overnight rate; and (ii) LIBOR is unsecured and factors in bank credit risk while SOFR is secured and is nearly risk-free (and therefore is likely to be lower and may move less than or opposite to LIBOR during periods of market stress). Also, the specific variation of SOFR that the AARC recommends as its first choice for the Successor Rate has not yet been created.

Due to this uncertainty, we have seen lenders and borrowers in the fund finance space take an approach similar to the "amendment approach" suggested by the Consultation. Usually, any replacement interest rate requires the approval of both the administrative agent and the borrower (often subject to a negative consent majority of lenders) and, at times, includes a provision that the rate cannot be materially worse for the borrower than LIBOR.

However, while this wait-and-see approach may give comfort to the parties for the time being, the actual implementation of an interest rate amendment may prove to be challenging if, as the Consultation notes, LIBOR becomes unexpectedly unavailable and a myriad of credit facilities need to be amended in a short period of time. We expect the fallback provisions used in syndicated loan agreements to continue to evolve in 2019.

### Market developments: Limited liability company divisions

Effective August 1, 2018, the Delaware Limited Liability Company Act (the "DLLCA") was amended to add a new Section 18-217, providing that any Delaware limited liability company (an "LLC") may be divided into two or more Delaware LLCs pursuant to a plan of division. The plan of division must set forth, among other things: (i) whether the dividing LLC will survive the division or discontinue its existence; (ii) the name of each resulting and surviving LLCs after the division; (iii) treatment of the LLC interests in the dividing LLC; and (iv) the allocation of debts, liabilities and duties of the dividing LLCs among the resulting and surviving LLCs.

After the division is effected, the resulting and surviving LLCs would be distinct and independent companies and the debts, liabilities and duties of such companies would be separately held by each of them as specified in the plan rather than being joint and several among them (unless the plan of division constitutes a fraudulent transfer). This amendment is expected to facilitate spinoffs and is a flexibility already provided for in the laws governing LLCs formed in certain of the other states, such as Pennsylvania and Texas.

Many syndicated loan agreements restrict borrowers and guarantors from effectuating mergers or consolidations with or into another party or transfers of their assets to another


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party. Clause (o) of Section 18-217 of DLLCA provides that for all agreements entered into prior to August 1, 2018, such restriction shall be deemed to apply to a division as if it were a merger, consolidation or transfer of assets, as applicable (the "Safe Harbor"). While the Safe Harbor is written broadly to apply to all agreements regardless of their governing law, it is not certain that a court applying laws other than that of Delaware would reach the same result. In the US fund finance space, almost all of the domestic vehicles used are Delaware entities, and most loan agreements are governed by New York law. Accordingly, we have seen certain lenders request, in connection with already-contemplated amendments, that: (i) the covenants restricting mergers, consolidations and/or transfers be expanded to include divisions; and/or (ii) the inclusion of a new covenant restricting divisions. In addition, documentation for new transactions is starting to address these issues and we expect to see continuing developments on the precise formulation of language in 2019.

**Market development: Tax reform**

On December 20, 2017, the United States Congress passed H.R. 1, known as the "Tax Cuts and Jobs Act", which was signed into law on December 22, 2017 (the "New Tax Law"). Even though it was enacted prior to this past year, its effects were first felt in 2018. The New Tax Law includes significant changes to the taxation of business entities. As an example, it places meaningful limits on the deductibility of interest expense, which, under certain circumstances, may make it less attractive for a borrower to issue debt. These limitations could affect funds (and indirectly, their investors) and may also impact lenders (including subscription facility lenders). To the extent that interest rates continue to rise, as they have recently, the effects could be more profound.

Another feature of the New Tax Law is a reduction in the corporate tax rate from 35% to 21%. This development prompted a number of fund sponsors to consider changing the legal form of their entities, in order to take advantage of the lower rate, and some have already executed on that strategy. There are numerous other amendments to the former tax treatment of several issues relevant to the operation of investment funds. As a result, we experienced an increased number of fund restructurings in 2018, and a corresponding need to modify subscription and other fund facilities that had been provided to such funds prior to the New Tax Law taking effect.

**Legal development: Beneficial ownership certification**

In May 2018, the US Treasury Department's Financial Crimes Enforcement Network (FinCEN) began enforcing a new rule under the Bank Secrecy Act that enhances customer due diligence requirements for financial institutions. The rule requires covered financial institutions to identify and verify the identity of the beneficial owners of all legal entity customers at the time a new account is opened. For purposes of a financing transaction, the borrower (and potentially other loan parties) are considered bank customers and are required to provide beneficial ownership information as part of the know your customer ("KYC") process. For legal entities, a "beneficial owner" is defined to include: (i) all individuals who, directly or indirectly, own 25% or more of the entity's equity interests; and (ii) at least one individual with significant responsibility to control the entity (e.g., director or senior officer or manager).

Banks now generally require completion of a beneficial ownership certification as part of the KYC process, and sometimes include provisions in fund finance documents regarding the completion and accuracy of such certifications. There are several exemptions from the


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requirement to provide beneficial ownership information. These include legal entities that are regulated US financial institutions, public companies and their subsidiaries, and pooled investment vehicles that are operated or advised by a regulated US financial institution. Closed-end investment funds generally qualify for this last exemption, although general partners or other loan parties subject to KYC requirements may not. In addition, pooled investment vehicles that do not qualify for the exemption are still only required to disclose one individual under the control prong, and not any 25% beneficial owners, due to the nature of investment fund ownership. Lenders and fund borrowers continue to negotiate the requirements concerning beneficial ownership certification, including ongoing compliance and reporting with respect to such certification. We anticipate that negotiations will continue in 2019, as market practice, guidance from regulators, and recommendations and requirements from compliance groups of both banks and funds, continue to evolve.

### Legal development: Regulation W

The Federal Reserve's Regulation W places quantitative and qualitative limits on "covered transactions" from banks to their affiliates (including fund affiliates). A bank may not enter into covered transactions representing more than 10% of its capital to any one affiliate, or more than 20% of its capital to all affiliates combined, and all loans and certain other covered transactions with affiliates must be collateralised (or even overcollateralised). The definition of "covered transaction" is broad, but notably includes, among other things, extensions of credit to the affiliate and purchases of securities. "Affiliate" is also defined broadly, and generally includes any company that controls, is controlled by, or is under common control with, the bank (it also specifically includes private funds for which the bank or a bank affiliate is an investment adviser, provided the bank and its affiliates own more than 5% of the equity of the fund). Importantly, Regulation W includes an "attribution rule", which treats any covered transaction, the proceeds of which are transferred to an affiliate, or used for the benefit of an affiliate, as a transaction with an affiliate.

While Regulation W was promulgated in 2002 and has not undergone any significant amendments by regulators in recent years, many funds receiving bank financing have faced increased requests from lenders to incorporate in loan agreements provisions that would require the fund borrower to track and report details of any on-lending from the fund to any third-party recipients – limited, in some cases, to recipients that may be affiliates of the lender. It should be noted that there are exceptions to Regulation W, including from the "attribution rule," and whether it applies to subscription facilities may depend on the facts and circumstances of each fund, and accordingly must be analysed on a case-by-case basis.

### Legal development: the Volcker Rule

The Volcker Rule, finalised in 2013 and in effect (for the most part) since 2015, has, among other things, placed considerable burdens on the abilities of banks to invest in, sponsor, or enter into certain transactions with so-called "covered funds", a term that includes, among other things, private funds exempt from registration under the Investment Company Act of 1940, in reliance on Sections 3(c)(1) or 3(c)(7) thereof, as well as many non-US equivalents of such funds. Under an exemption designed to reduce the extraterritorial application of the Volcker Rule, non-US banks may invest in or sponsor covered funds if such activity takes place "solely outside the United States".

This exemption, the so-called "SOTUS Exemption", includes a number of requirements for a bank or bank affiliate to show that its activity meets the "solely outside the United States"


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standard: (i) the banking entity acting as sponsor or acquiring or retaining the ownership interest in the covered fund must not be located in the US and must not be controlled, directly or indirectly, by a banking entity that is located in the US; (ii) the banking entity – including relevant personnel – making the decision to sponsor or invest in the covered fund must be outside the US; (iii) the investment or sponsorship must not be accounted for, directly or indirectly on a consolidated basis, by a US branch or affiliate of the banking entity; and (iv) financing for the investment or sponsorship must not be provided, directly or indirectly, by a US branch or affiliate of the banking entity.

In an advance notice of proposed rulemaking in May 2018, the Volcker Rule agencies indicated that they are considering retaining the first three requirements but removing the fourth. The effect of this change, if finalised, would be to loosen the exemption and permit more US-based financing for acquisition or retention of covered funds by foreign banks and their affiliates. In practical terms, the scope of the effect of this change is unclear, but we would expect to see at least some shift in such financing by foreign banking entities from their non-US affiliates to their US affiliates.

## Conclusion

The year of 2018 brought many notable developments and, overall, was a successful year for private fundraising and fund financing. We expect that 2019 should continue on a positive note, although the economy overall may be facing some headwinds. It will be interesting to monitor the effects of recent developments, such as further impact of the tax reform and LIBOR replacement issues, and the extent and fashion that they are absorbed by and reflected in the markets. We also believe that the recent spotlight on subscription finance has contributed to a better understanding of the product by the general public in addition to the deeply engaged participants – and expect a dynamic discussion to continue.

However, 2018 has shown that, even with this dialogue as a background, investors continue to participate in funds employing leverage. It has, however, served as a good reminder that keeping open lines of communication among lenders, fund sponsors and investors, including with respect to subscription line facilities, can and has contributed positively to the development of fund financing in the mutual best interest of all constituencies.

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## Endnote

1. The various data points cited herein are sourced from Preqin publications, reports and updates.


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