THE FUND FINANCE MAGAZINE

CRD6 – LUXEMBOURG, THE SOLUTION FOR UK, US AND OTHER NON-EU FUND FINANCE LENDERS?

FROM NICHE TO NECESSITY? THE RISE OF SUB LINE AND NAV FACILITY RATINGS

With contributions from

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ABOUT THE AUTHOR

Michael Mbayi

Michael Mbayi is the Head of Banking & Finance at **Praxio Law & Tax**. **Michael** is one of the most experienced fund finance lawyers and advises leading financial institutions, private funds sponsors and alternative lenders on a wide variety of transactions including subscription facilities, hybrid/ NAV facilities, as well as GP and Management fee facilities.

Michael was **awarded** in 2021 by **Fund Finance Association** for his contribution to the industry. **Michael** has been **recognised** in 2022 by "**The Drawdown**" as one of the most influential Fund Finance experts. **Michael** has been **quoted** by **Legal 500 EMEA 2022** as "very knowledgeable on Fund Finance matters", "responsive" and "particularly active on behalf of a lender-focused client base".

Michael is the author of various Fund Finance publications and a member of the Diversity Committee of the Fund Finance Association.

Beyond Fund Finance, **Michael** is involved in banking regulatory, structured finance and capital market transactions.

Editorial

Dear Friends,

This is with a great pleasure that we issue the first edition of our Fund Finance Magazine.

The magazine starts with an article regarding the regulatory changes which will bring CRD6 and how this may impact the activity of US, UK and other non-EU lenders providing fund finance solutions to Luxembourg investments funds.

Benjamin James from **Alpha Group**, will share with us his perspectives about the fund finance market.

Emily Fuller and **Alex Short** from **Haynes Boone** will then introduce us to the key structuring considerations for financing open-ended funds.

Julia Keppe, **Zöe Hallam** from **Walkers** and **Tom Speller** from **KBRA** will cover the timely topic regarding the rating of sub-lines and NAV facilities.

Reis Duarte from **Cadwalader** will dig into practical considerations regarding the structuring of the security package with an article about dual security.

We hope that you will enjoy the reading of this first issue!

Michael Mbayi

Thanks for their contributions:

ALPHA
CADWALADER
HAYNES BOONE
KBRA
Walkers

CONTENT

PRAXIO
Law & Tax

ABOUT PRAXIO LAW & TAX

We are an independent multi-service law firm in Luxembourg. As corporate, finance, investment funds and tax attorneys, we service clients in all matters related to business law and both direct and indirect taxation. We are able to handle the most complex cross-border legal, regulatory and tax structuring matters, along with any commercial or business litigation. Our senior professionals have significant experience in advising private equity houses, multinationals, family offices and high-net worth individuals during their entire business and private estate life cycle from initial acquisition structuring and financing through restructuring and refinancing to exit, disposals and estate transmission.

We advise the leading financial institutions acting as lenders, in a wide range of fund finance, real estate finance, leverage finance and structure finance transactions.

Our legal teams have longstanding expertise in helping clients to structure private equity and venture capital transactions within regulated and non-regulated investment vehicles. This support includes negotiating the acquisition and financing, and subsequently drafting the relevant documents. We also assist with the drafting and tax structuring of management incentive arrangements and their implementation. Our clients appreciate us for our clarity, practical solutions, timeliness and efficiency.

The members of our firm have completed high-level academic training in the Luxembourg, French and Anglo-Saxon legal systems and are able to work in a trilingual environment. Our business lawyers work closely with fellow professionals in key foreign jurisdictions, enabling us to coordinate investment and structuring/restructuring projects in Luxembourg and abroad. We see ourselves as business partners and not solely as lawyers. We are committed to providing our clients with:

A full understanding of their business and culture;

A thorough focus on their objectives, both short-term and long-term;

An unwavering commitment to helping them solve their problems in the most efficient and cost-effective way. If something does not make commercial sense to our clients, it does not make sense to us.

Highly committed to the fund finance industry, Praxio's fund finance team, lead by our Head of Banking & Finance, Michael Mbayi, is involved in a wide range of transactions including subscription facilities, NAV facilities, hybrid facilities, and GP and management fee facilities.

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CRD6 – LUXEMBOURG, THE SOLUTION FOR UK, US AND OTHER NON-EU FUND FINANCE LENDERS?

BY MICHAEL MBAYI HEAD OF BANKING & FINANCE (PRAXIO LAW & TAX)

Being the second fund domicile globally in terms of assets under management and the most preeminent fund domicile in Europe, Luxembourg is involved in a number of fund finance transactions, including subscription facilities, NAV facilities, GP and management fee facilities and other bespoke fund finance solutions.

Luxembourg fund finance market is mainly cross-border, since credit institutions acting as lenders are generally established outside Luxembourg, while we have seen the development of a domestic market as well, with local branches of foreign credit institutions and local credit institutions being more and more involved in the industry.

A EU credit institution, may benefit from the EU passport and provide loans to borrowers established in Luxembourg. Conversely, a third-country credit institution (i.e. non-EU), may not benefit from the EU passport. Currently, the third-country credit institutions have mainly four options to provide loans to borrowers established in Luxembourg:

- Provide loans on occasional basis, subject to the prior written authorisation of the Luxembourg regulator (the CSSF);
- Establish a Luxembourg branch;
- Establish a subsidiary in the EU which may benefit from the EU passport; or
- Rely on the so called, reverse solicitation (i.e. a solicitation coming from the borrower itself).

The new European Union Capital Requirements Directive 6 (CRD6) will aim to uniform within the EU, the conditions for providing financial and core banking services.

Further to the implementation of CRD6, non-EU credit institutions will not be any more authorised to provide loans on occasional basis with the prior approval of the Luxembourg regulator and the remaining options would be:

- Establishing a Luxembourg branch;
- Establishing a subsidiary in the EU which may benefit from the EU passport; or
- the reverse solicitation.

It means that non-EU credit institutions, providing fund finance solutions to investment funds established in Luxembourg, will need to assess which is the best route to continue to provide loans to Luxembourg funds.

Establishing a Luxembourg branch may be a good solution for lenders focusing on Luxembourg funds, since the majority of European funds are established there.

Establishing this EU subsidiary in Luxembourg, would permit to this subsidiary to benefit from the assets of Luxembourg as a jurisdiction, being notably a stable country and economy with a AAA credit rating, a predictable legal system, a multilingual workforce, and a jurisdiction in the centre of Europe with international reach.

In any case, in light of the objectives of the credit institution, discussions with Luxembourg lawyers specialised in fund finance and banking regulatory would be recommended to establish the best strategy. Indeed, this new regime should be applicable already in course of 2026.

The present does not constitute a legal advice and is provided for information purpose only. No one should act upon such information without appropriate advice after a detailed analysis of the particular facts in case.

Michael Mbayi

Michael Mbayi is Head of Banking & Finance at **Praxio Law & Tax**. Michael has in depth knowledge of the Fund Finance market and a long-standing experience in Fund Finance. He advises financial institutions as lenders on a wide variety of transactions including subscription facilities, hybrid/NAV facilities, and other bespoke Fund Finance solutions. Beyond Fund Finance, **Michael** is involved in banking regulatory, structured finance and capital market transactions.

PRAXIO
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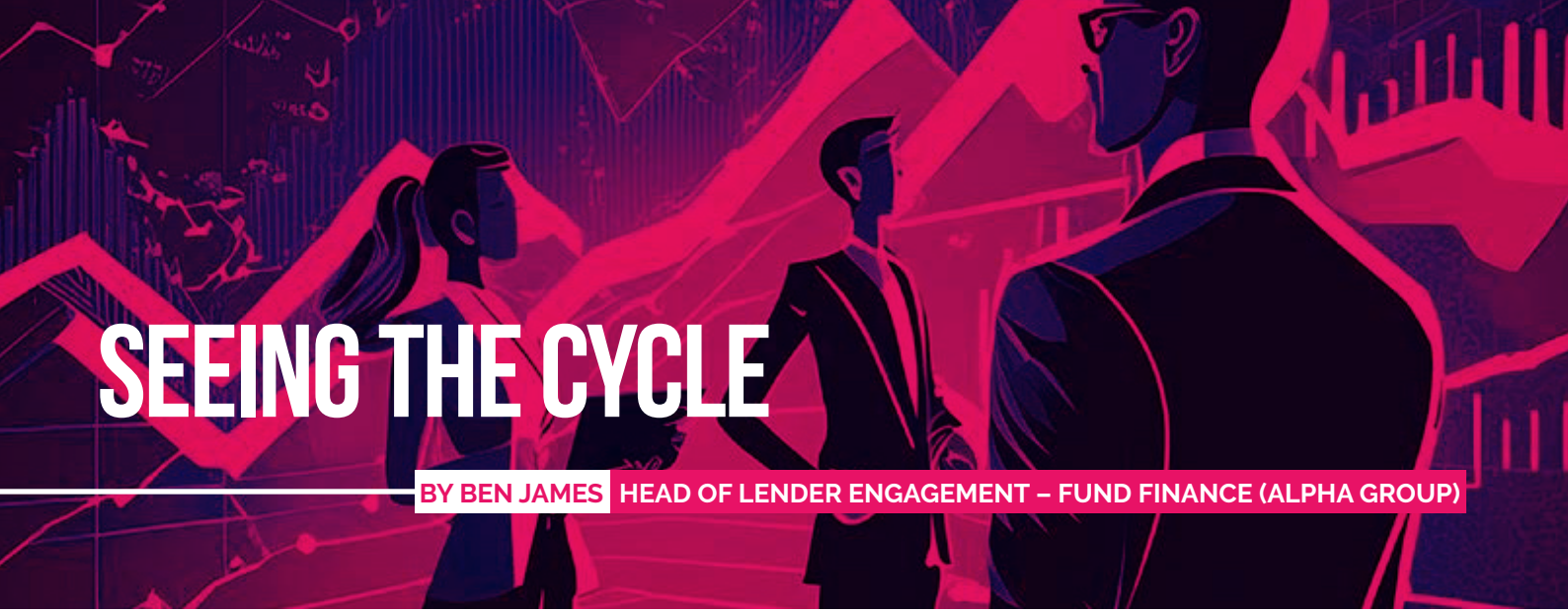

SEEING THE CYCLE

BY BEN JAMES HEAD OF LENDER ENGAGEMENT – FUND FINANCE (ALPHA GROUP)

Looking at the fund finance landscape through a wide lens paints a more optimistic liquidity picture and highlights the formation of a natural cycle in the market, one we have witnessed in other industries.

When discussing the availability of liquidity in the fund finance market today, conversations are often littered with terms such as 'retrenching', 'constrained' or 'supply and demand mismatch.'

However, fund finance lenders are facing a set of unique challenges and it's worth stepping back to better understand the driving forces behind the tougher conditions present in the market today. Looking at the fund finance landscape through a wide lens paints a more optimistic picture than a lot of market commentary would have you believed and highlights how much liquidity is actually available.

Regulatory pressure

The final elements of Basel III (aka Basel III Endgame, Basel 3.1 or Basel IV) are due to be implemented globally, with US and UK regulators proposing a July 2025 compliance date, while European regulators have agreed on January 2025.

However you want to label these rules, their impact is the same; banks must change the way they calculate risk (no longer being able to use their own internal ratings) and crucially, will be forced to hold more regulatory capital.

On top of this, US regulators are implementing increased capital charges for globally systemically important banks, via capital buffers and surcharges, as well as demanding more stringent reporting, further dampening the attractiveness of the fund finance space.

The capital adequacy rules have shifted the economics of fund finance loans for banks, making them far less attractive. Subscription lines have typically been low margin products, historically ranging from around 1.5% to 2%. Broadly speaking, margins for sub lines are now at around 2% to 2.5%, depending on currency. On top of that, with banks needing to hold larger reserves against these facilities

the cost of providing these loans is less economically viable, and most of all, restricts banks' ability to provide other, more attractive products.

Perhaps the most notable impact of these new rules was reported back in September 2022, with Citigroup scaling back its sub line book from $65bn to around $20bn.

Market consolidation

The past year has also seen a small wave of consolidation in the market. In March 2023, HSBC bought SVB UK; then, **Goldman Sachs** and **PNC** each bought a portion of Signature Bank's subscription loan portfolio; and **JPMorgan Chase** bought First Republic Bank.

All three acquired lenders were highly active in the lower and mid-cap fund finance markets, but despite having been incorporated into larger entities, these recent events have added to the growing sense of supply constraints.

Natural evolution

These two factors combined have led to a widely accepted narrative in the market about banks retrenching and the emergence of a liquidity gap.

However, Alpha Match has captured more than 290 lender profiles. By engaging directly with these lenders, we track up to 80 data points for each lender, including average loan amounts and their lending preferences.

Looking at the fund finance market via the wide lens afforded by the platform shows a highly liquid market, with lenders active right the way across the spectrum of managers.

For me, what's happening in the fund finance market at the moment seems entirely natural and akin to similar cycles we have seen in other industries. Take the professional services market for example; the big four have emerged as the largest players servicing the largest clients, which has created space for smaller, more boutique shops to emerge, serving smaller clients. The same is also taking place in the fund administration market, where several years of aggressive consolidation (largely backed by private equity) has led to the formation of a handful of very large organisations, which have naturally

gravitated towards larger clients. Meanwhile, a spate of spinouts and boutiques have launched in their wake, sweeping up the smaller end of the market.

Alpha Match evidences the same pattern in the fund finance lender landscape. Yes, due to regulatory constraints and consolidation, some lenders are reducing relationships and doubling down on larger funds. But crucially, we are witnessing an influx of new entrants to the market, keen to fill the void left by this shift. Indeed, according to our data, 35% of the lenders we track can provide subscription lines of less than £50m.

These recent entrants to the market are generally newer (either entirely new outfits or new teams focusing on fund finance within established institutions) and are therefore less prominent or recognised by borrowers at the moment.

However, through Alpha Match, a digital debt intermediator, we are able to connect these incoming sources of liquidity to the funds that are no longer being served by banks naturally moving up the value chain.

If you would like to find out more about how we work with lenders or to join Alpha Match and boost your dealflow, please drop me a line on match@alphagroup.com

Ben James

Ben James is Head of Lender Engagement for Alpha Match, **Alpha Group's** digital debt intermediary.

Prior to joining in November 2023, **Ben** spent two years at NatWest Markets where he focused on structuring fund finance transactions. Previously, he spent five years at Deloitte establishing the Fund Finance Advisory team. He began his career at Barclays, where he spent five years, which included working in London and New York with the bank's Financial Institutional Group for corporate and investment banking.

ALPHA

PRAXIO'S FUND FINANCE SECURITY GUIDE

Download our Fund Finance Security Guide to discover the main aspects of the security package in the most common jurisdictions involved in fund finance transactions.

Our guide covers the following jurisdictions:

- Luxembourg
- Australia
- Cayman Islands
- England and Wales
- France
- Germany
- Guernsey
- Hong Kong
- Ireland
- Jersey
- Mauritius
- Scotland
- Singapore
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Cadwalader – CADWALADER

Fried Frank – Fried Frank

Haynes Boone – HAYNES BOONE

Maddocks – Maddocks

Matheson – Matheson

Mayer Brown – MAYER|BROWN

Mourant – mourant

Reed Smith – ReedSmith

Stephenson Harwood – STEPHENSON HARWOOD

and Walkers – Walkers

Download it now: https://praxiolegal.com/praxios-fund-finance-security-guide/

CONSIDERATIONS WHEN PROVIDING A SUBSCRIPTION-LINE TO AN OPEN-ENDED BORROWER

BY EMILY FULLER PARTNER (HAYNES AND BOONE CDG, LLP)

AND ALEX SHORT ASSOCIATE (HAYNES AND BOONE CDG, LLP)

When providing financing to an open-ended fund it is critical that the lenders understand the mechanics of the fund so as to structure the loan documentation in a way that maximises the potential borrowing base while still providing satisfactory protection for the lenders, without onerously restricting the day-to-day business of the fund. In this article we will look at the elements in a transaction that a lender should consider when a fund is structured as open-ended, focusing particularly on the issues arising around ongoing redemptions of investor capital.

Investment funds are generally split into one of two types of structures (or a hybrid in between): closed-ended or open-ended.

'Closed-ended' funds refer to funds where investors are not generally able to extract their capital at their request prior to dissolution of the fund, unless they are able to sell their interest in the fund in line with any transfer provisions. Closed-end funds are ideal for investing in assets which benefit from a longer 'hold' period and are therefore by definition more illiquid (for example, real estate funds). They have definitive time periods during which new investors can be admitted, and outside of those time periods the fund is 'closed' to potential investors. Closed-ended funds will also have a pre-determined lifetime, and during that lifetime there will be specific time periods for active investments and then disposal of those investments. However, there may be some exceptions where investors in closed-ended funds are required to redeem for legal, tax or regulatory reasons (for example, an investor that is subject to the United States Employee Retirement Income Security Act of 1974, as amended ("**ERISA**"), may have its interest compulsorily redeemed if its interest in the fund could risk the fund being deemed to hold "plan assets").

'Open-ended' funds, on the other hand, typically will permit an investor to redeem its interests at times and in the manner set forth in the fund's constituent document, have an 'open' fund-raising concept when they can accept new commitments and new investors, and generally hold more liquid assets (for example, credit funds and hedge funds). As the portfolios of open-ended funds are more liquid, they are able to dispose of assets in order to generate cash without negatively affecting their whole portfolio and can therefore meet investor redemption requests, if required. As open-ended funds have more liquidity

1. Within the meaning of 29 C.F.R §2510.3-101, et seq, as modified by Section 3(42) of ERISA.

than closed-ended funds, historically they have been less likely to utilise subscription lines.

Additionally, as subscription lines are secured against the investors' uncalled commitments, and the amount available to a borrower under the facility is determined in reference to the uncalled commitments of the investors deemed creditworthy enough by the lender to be included in the borrowing base ("**Included Investors**"), the two issues that arise with offering a subscription line to open-ended borrowers are how does a lender (i) track the investor pool, and (ii) protect itself from becoming over-exposed due to investor redemptions.

Due Diligence:

It is important to understand the redemption mechanics that are laid out in the constitutional documents of a fund. Questions a lender (or their counsel) should seek to answer at due diligence stage include:

1. Do the holders of all interests in the fund have a right to redemption or are there different tranches that have different redemption rights attached to them?
2. Can redemptions be requested at any time, or is there a lock-up period during which redemptions cannot be requested (for example, a certain number of months or years following the admission of that investor)? An example of the typical 'lock-up' wording we see included in fund constitutional documents is as follows:

"*Limited Partners may not request a Requested Redemption Date that falls within their respective "Lock-up Period", which is the period starting from the date on which Limited Partnership Interests relating to their respective Commitment (or, as the case may be, the increase of their respective Commitment) are first issued and ending 3 years thereafter.*"

3. Are there any requirements that an investor has to meet in order to deliver a redemption request? For example, giving a certain number of days' notice in advance of a requested redemption date.
4. Can redemptions be made at any time or do they have to align with certain time periods, e.g. at the end of each financial quarter?
5. Are there any instances in which redemptions may be suspended or limited? For example, the right to request a redemption may be suspended if redemption requests exceed a certain percentage of the fund's net asset value

("**NAV**") at a particular point in time, or if the calculation of NAV itself has been suspended due to external events. Redemption requests may also be limited by the fund's management in order to prevent a 'run' on the fund in times of low liquidity, e.g. only permitting redemptions to be requested during a certain period (also referred to as 'redemption gates'). Where a fund has redemption gates built into its structure which apply at all times (rather than just when liquidity is low), then the fund is deemed to be more of a hybrid between a closed-ended and open-ended fund, rather than being truly open-ended.

6. Does the general partner/manager of the fund have any discretion when it comes to satisfying a redemption request?

7. What happens if there are not sufficient liquid assets available to satisfy all redemption requests received? There are a number of ways that funds may be structured to deal with this, including to (i) satisfy redemption requests on a pro-rata basis rather than in full, (ii) create a queue system where the redemption requests are prioritised in the order received, or (iii) prioritise redemption requests received from investors whose interests in the fund are valued at lower than a certain monetary threshold. An example of the typical 'queue system' wording (as mentioned in (ii) above) we see included in fund constitutional documents is as follows:

"*For so long as one or more Redemption Requests remain outstanding for more than 24 months from the relevant Requested Redemption Date, the General Partner may decide in its sole discretion to first satisfy Redemption Requests made on earlier Requested Redemption Dates…*"

Exclusion Events:

When drafting the exclusion events (i.e. events which, if they occur, would trigger the exclusion of an investor from the borrowing base) ("**Exclusion Events**") in a facility agreement, it is important to capture any events which could decrease the value of the uncalled commitments of the Included Investors.

Crucially, lenders will want to ensure that they do not lend against the uncalled commitments of interests which are redeemed. This is typically not an issue in closed-ended funds, but becomes much more relevant and nuanced when dealing with open-ended funds. The applicable Exclusion Event is usually triggered by receipt of a redemption request, but consideration should also be given to whether it is appropriate to tie the Exclusion Event to confirmation by a general partner/manager that it will satisfy a redemption request or the occurrence of a certain redemption date. The trigger event will depend on (i) the notice requirements for such redemption request in the fund's constitutional documents, (ii) whether the general partner/manager has discretion as to whether to satisfy such request or not, and (iii) what mechanics are in place in case the fund is unable to satisfy a redemption request.

For example, if a redemption request has to be submitted three months in advance of the next redemption date, or there is not sufficient liquidity to meet all redemption requests and a request is put into the back of a queue system, then the uncalled commitments attached to the investor's interest that is subject to such redemption request could be unnecessarily excluded from the borrowing base. Such a scenario is not in the best interests of the borrower or the lender, so it is important for lenders and borrowers to structure Exclusion Events that are tailored to the redemption mechanics. In practice, subscription-lines

are usually put in place for a short period of time (and in the current market this has been reduced to a typical tenor of one to two years) and the facility will likely expire before the lock-up period (see point 2 above) has passed, meaning that the investors' right to request a redemption will not arise during the lifetime of the financing.

It is also important to note that a redemption request may be made in relation to only a portion of an Included Investor's interest in the fund and in this case the uncalled commitments relating to the remaining portion is not subject to a redemption request should not be automatically excluded from the borrowing base.

Representations:

The borrower should provide a representation to the lender on the signing date of the financing which either (i) states that no redemption requests have been received to date, or (ii) confirms that it has provided copies of all redemption requests received to date to the lender.

Information undertakings:

The borrower should undertake to provide a copy, or otherwise provide details, of any redemption requests received by investors promptly to the lender following receipt of the same, together with confirmation of any redemptions that have been completed. This is important for all investors, as a lender will need up to date details of the investor pool in the event it needs to enforce its security and serve a capital call notice on the investors.

Likewise, each time an investor is admitted (as is common throughout the lifetime of open-ended funds) there will be an ongoing requirement to give notice to that investor of the existence of the capital call security to ensure such security is effective under any local law requirements and deliver any applicable subscription documents to the lender. Timing of delivery of the notice and any conditions of evidence of access by each new investor will be negotiated between the fund and the lenders.

If there are any events that could trigger the suspension or limitation of redemptions, a borrower should also be obligated to notify the lender upon the occurrence of the same.

Undertakings and prepayment:

There should be a provision in the facility agreement which requires a prepayment of any excess amount outstanding under the financing if the borrowing base limit is exceeded. Depending on the drafting of the Exclusion Events and the redemption mechanics, it may be appropriate to require an undertaking by the borrower that it will not satisfy any redemption request made by an Included Investor unless a prepayment is made to the lender prior to such redemption in the amount which would be in excess of the borrowing base limit immediately following the redemption.

Events of Default:

As per point 5 above, an open-ended fund will often include mechanics to prevent a 'run' on the fund. However, a lender may want to be able to step in and pull the financing prior to reaching any such limit. In such cases, or where there is no such limit in the fund documentation, the facility agreement may include an event of default which would be triggered when a certain percentage of investors submit redemption requests.

Conclusion:

Although open-ended funds are more liquid than closed-ended funds, meaning traditionally it has been the latter that utilise the subscription line as a financing tool, we have seen an increase in the number of open-ended funds requesting subscription lines. In the current climate we expect to see borrowers seek out any sources of liquidity available, and in turn the fund finance industry responds with tailored liquidity solutions.

FUND FINANCE EXPERT TALK

Praxio's Fund Finance Expert Talk is the rendez-vous, in which, our Head of Banking of Finance, **Michael Mbayi**, invites key industry leaders to share their personal story and to give some expert tips.

These series have three main objectives:

- **To inspire**: discover the guest's personal story and strategies used to become a successful industry leader.
- **To teach**: Michael and his guest will develop a technical point related to recent development or a major topic in fund finance.
- **To inform**: there is a market update during the discussion.

The talks can be watched on our YouTube Channel https://www.youtube.com/@Praxio

Past episodes:

Ep. 1 With **Emma Wang**, General Manager, **East West Bank**, Hong Kong Branch.

Ep. 2 With **Fantine Jeannon**, Executive Director and Head of Operations and Treasury with **LGT Private Debt**.

Ep. 3 With **Mike Mascia**, Co-Head Fund Finance at **Everbank**.

Ep. 4 With **Emma Russell**, Partner and Head of the Finance Practice Group at **Haynes Bonne** in London.

Subscribe to Praxio Law & Tax LinkedIn page and our You Tube channel, if you don't want to miss the future episodes!

FROM NICHE TO NECESSITY? THE RISE OF SUB LINE AND NAV FACILITY RATINGS

BY JULIA KEPPE GROUP PARTNER (WALKERS) — ZOË HALLAM GROUP PARTNER (WALKERS)
AND TOM SPELLER MANAGING DIRECTOR (KBRA)

Banks and GPs are increasingly looking to have fund facilities rated, whether for syndication purposes or regulatory reasons. To discuss the trend towards rating sub line and NAV facilities, Zoë Hallam and Julia Keppe, co-heads of the Walkers' Channel Islands funds finance practice, sat down in a conversation with KBRA's Managing Director and Head of European Funds Tom Speller.

Zoë: Let's start with setting the stage with respect to the rating of sub line facilities. Until recently, this was a pretty niche market within fund finance, but that seems to be changing. Can you talk us through your experience so far?

Tom: KBRA has been pretty active in rating all transaction types falling under a fund's umbrella, including fund finance, which covers NAV and subscription line facilities. Our rated portfolio has grown to over 400 transactions now, and a lot of that growth has been driven by fund finance.

Around half of our rated transactions portfolio is under the fund finance umbrella, and that's split maybe 50:50 between NAV loans and subscription lines. I'd say the 50:50 split has really evolved over the last year, largely driven by the growth of ratings in the sub line space.

Historically, our ratings for subscription facilities have been private ratings, which have then been used for syndication. So, for example, a lender instructing us for a rating to syndicate part of that facility to an investor that would find a rating beneficial, like an insurance company.

That's continued from last year into this year, and we'd expect a continuing demand for ratings given lenders are looking to reduce, potentially, a single name concentration risk. I think single name concentration risk is probably something that's on the rise across banks as a result of the increasing size of funds and extra demands placed on some relationship banks as a result of a drop in supply from, for example, the US banking crisis last year.

In addition, we've seen a continued increase in requests from certain banks to acquire ratings for internal risk validation or for regulatory capital purposes. So, this can either be in the form of a private or a

published rating. The increase in published ratings we've issued in the last couple of years is driven by that purpose. We expect to see that continue as upcoming regulatory changes come into force and banks need to use external ratings on certain exposure types, like sub lines.

Julia: We know you have a very successful ratings business in the US. Is this change in the fund finance market unique to Europe, or are you seeing the same shift in the States?

Tom: For sure. Historically, most of our subscription line ratings have been driven by European lenders, usually for syndication. But since we've seen the growth in published ratings, we're also getting requests and engagements from North American banks who need ratings with a similar rationale to their European peers. Some are looking to syndicate, but some need ratings for regulatory capital purposes.

We're also aware some banks are exploring some form of structural solutions that would help to reduce exposure to subscription lines and increase balance sheet capacity. This might look like a synthetic risk transfer, or other structures that might leverage securitisation technology. Some of this needs a rating or assessment of the underlying subscription lines that forms the underlying collateral. So, overall, I think we're seeing the ratings growth both in Europe and North America for similar rating drivers.

Julia: The other thing that we really wanted to know is who's driving demand for ratings? Clearly, when this all started, it was a lender-led process. However, do GPs want these as well?

Tom: Yes, we're starting to see a growing awareness of the fact that the ratings, or soliciting a rating, can help to source liquidity. That also applies to subscription lines. We've also seen a few requests from sponsors who, at the early stages of a facility, are looking to get the whole facility rated for more certainty on the financing they're asking for.

For example, if GPs are bringing in alternative types of lenders that might benefit from a rating, it's potentially beneficial to have a rating on the entire facility. We usually work with individual banks with rating their involvement in a

facility, but we're seeing a potential market evolution where the sponsors are asking for the whole product to be rated. I think that could broaden the type of lenders we see in this space and maybe bring in alternative lenders and investors too.

Zoë: So far, we've discussed sub line rating market, but you mentioned your book is a 50:50 split with NAVs. Do you have any comments on rating NAV facilities?

Tom: NAV facility rating demand is as strong as ever, particularly for more concentrated NAV loans (facilities extended to buyout funds, for example). We've rated in excess of 100 NAV loans, which includes the more concentrated types of NAV loans, but also secondaries and credit facilities to private credit funds.

It's typically investors driving these ratings, who will benefit from a rating on the part of the loan they are looking at; a bank might then instruct us at KBRA to rate its participation as part of a syndication to such an investor. It's also for asset managers who are actually investing on behalf of certain investors, like an insurance company, and, therefore, rating their participation in the facility.

We're continuing to see NAV financing innovations. What comes to mind is an increased use of preferred equity and broader LP or GP solutions, which may allow borrowers to monetise parts of their existing interests while keeping some of the upside.

From a ratings perspective, we see these more in other forms. For example, a preferred equity solution that may serve as the collateral for a NAV loan. We then rate that NAV loan, which is ultimately secured by the preferred equity interest, with the underlying collateral being a NAV of a fund or multiple funds.

Ratings of hybrid deals are also on the rise. One example of this would be a facility to a continuation fund, and the facility combines the security package of a sub line and a NAV loan with, for example, a pledge on the underlying asset and rights to distributions from the asset. We expect to see an increase in continuation funds given the slowdown in PE exits.

Julia: Last question, Tom. If we're having this conversation again in 12 months' time, what do you think we're going to be talking about? More of the same, new products? What do you think?

Tom: I alluded to this earlier, but I think we're probably going to see continued innovation by lenders in the coming year to meet some of the demand from funds. We've all seen the global slowdown in fundraising for some sectors, but funds are continuing to grow in size with some of the larger sponsors seemingly able to defy that slowdown. Similarly, lenders are looking for ways to free up some of their balance sheet capacity. They're after some innovative solutions to reduce some of those single name exposures across facilities.

With the increase in interest rates and, generally speaking, very strong credit outcomes on subscription lines, there may be more interest from investors to come in to some of the subscription line markets. Likewise, we may see banks and other lenders exploring ways in which they can bring in different types of investors that may have different risk return profiles to take part in sub lines. Using things like securitisation technology could let different investor

types take part in different tranches of exposures ultimately secured by sub lines.

In the NAV space, given some of the slowdowns and realisations, sponsors are looking for new solutions to recapitalise portfolio companies and return capital to LPs. As a result, we expect the hybrid facilities market, and our ratings activity for those facilities, to continue growing.

This conversation is based on the podcast We Talk Banking & Finance with Walkers, launched on 26 January 2024. If you'd like to listen to the episode, please click here.

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Julia Keppe is a member of Walkers' Banking & Finance practice group in Jersey, leading the Jersey Fund Finance practice and co-heading the Channel Islands team alongside Zoë Hallam. **Julia**'s broader finance practice also encompasses leveraged acquisitions, corporate lending, direct lending, debt capital markets and restructurings / special sits, representing corporations, private equity sponsors and financial institutions. She has been practising since 2006 in London, New York and offshore, and is recognised by Legal 500 and Chambers.

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Tom Speller

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Our Fund Finance Webinar Series are online live events hosted by our Head of Banking & Finance, Michael Mbayi, where he has in depth discussions with a panel of industry experts and where the audience may interact with these experts.

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DUAL SECURITY STRUCTURES IN CAPITAL CALL FACILITIES – BELT AND BRACES OR COUNTERACTION?

BY DUARTE REIS ASSOCIATE (CADWALADER)

At present a staple in the private equity markets and a core element in fund sponsors' capital deployment strategies, subscription lines of credit started as modest tools for cash management in private equity. Originally, these products acted as short-term bridges documented through revolving loan facility agreements, secured by limited partners' uncalled commitments and meant to be repaid within 90 days, allowing general partners to act swiftly on investment opportunities without waiting for capital calls.

Although capital call lines have evolved significantly since their inception, the core components of the lenders' security package have remained largely the same and the primary recourse of the lenders is still to the undrawn capital commitments. The fund will typically grant security interests over (1) its rights to the investors' unfunded capital commitments (including the ability to call capital and other ancillary rights) and (2) the accounts to which such commitments are to be paid under the fund and investor documentation.

Fund finance lenders have become very familiar with the roll of requisite finance documents required for a capital call facility, and English law is often the preferred choice of governing law, owing to the robust legal framework which offers well-established principles and neutrality, fostering confidence and predictability. In the European market, the prevalence of English law extends to capital call facility agreements – however, the parties' freedom to choose the governing law of the security documentation for the facility may be restricted by other concerns. The prevailing principle in most jurisdictions, *lex loci rei sitae* or *lex situs*, dictates that (generally speaking) the law of the location of the assets to be subject to the security interests should govern the creation and perfection of those security interests.

While the application of this principle is fairly straightforward for bank accounts (e.g., security over a bank account in

1. Lenders should also look to put investors on notice to avoid good faith claims if the investors act in a manner which is adverse to the creditors' interests. Importantly, in situations where the fund releases investors (reducing their commitments to zero), this notification can be used to argue against the validity of such release.

England will typically be governed by English law), it may not be as obvious with intangible assets such as the fund's claims over investors' commitments. EU law offers guidance here as article 14 of the Rome I Regulation indicates that the law governing the underlying claim or right which is subject to the security should dictate (1) its transferability, (2) the relationship between the security taker and the debtor, (3) the circumstances under which the pledge or assignment can be invoked against the debtor and those under which the debtor's obligations may be validly discharged. The security document relating to the investor's undrawn capital commitments will therefore usually be governed by law governing the fund's constitutional documents and subscription documentation, as will the related perfection formalities. However, Rome I remains silent concerning the validity of security over claims vis-à-vis third parties. In Luxembourg, the top EU jurisdiction for fund domicile and the second largest globally, there is debate among practitioners over whether, according to internal conflicts of law rules, the law of reference is the law governing the claim or the law of the domicile of the debtor of the claim (i.e. in a subscription finance transaction, the investor). If the law of the domicile of the debtor is the law of reference, it could imply that non-Luxembourg investors in a Luxembourg fund should be notified according to the local rules that apply in the jurisdiction where the investor is domiciled. If this is the case, this would clearly pose an additional administrative burden for fund sponsors, particularly in complex fund structures with multi-jurisdictional investor bases.

In practice, seasoned Luxembourg fund finance legal practitioners are able to draft the underlying security documentation so that the lenders have sufficient comfort on these aspects..

Some participants go a step further. Across the pond, it is a relatively common practice in the U.S. market to establish parallel or dual NY law governed security arrangements over the same claims when dealing with entities from other jurisdictions – e.g. a New York law governed pledge over capital call rights and a Luxembourg law pledge over the same assets. To perfect the security, the New York security agreement is then subject to registration via a UCC-1 statement filing. Conversely, a Luxembourg law pledge over claims is perfected upon the execution of the agreement by the parties – nevertheless, notice of the Luxembourg security interest should be served on the investors, as the underlying debtor can otherwise rightfully discharge its payment obligations directly to the pledgor.

The aim of this approach is to give flexibility for the lender to choose the jurisdiction in which to enforce its security, arguably serving as a mechanism to diminish the risk of non-recognition of the choice of law in multi-jurisdictional transactions. This security arrangement may seem attractive for lenders faced with a structure involving exclusively or predominantly U.S. investors subscribing in a foreign fund or in a multi-layered (or master-feeder) structure where a feeder fund is domiciled in the U.S.

In the world of secured debt, there are often multiple creditors vying for a claim on the debtor's assets. When several security interests held by different creditors converge upon the same collateral, the question of ranking arises. But the scenario here is different – the same secured party holds not one, but two, security interests over the same exact assets as security for the same liabilities, in different jurisdictions. At first glance, one might think this is straightforward and has an easy solution – lenders can simply choose the most advantageous forum and enforce. But there are potential pitfalls in some jurisdictions and private international law and conflicts of law rules in each jurisdiction may not have legal rules governing the co-existence of security interests over the same assets, in favour of the same lender, securing identical secured obligations, which can create uncertainty and risk at the very time lenders want as little of that as possible – enforcement. And so the presence of these dual security interest arrangements may introduce potentially unforeseen consequences if not considered carefully at the outset, as these overlapping claims may create legal ambiguity depending on the jurisdictions involved.

As in all circumstances, devising adequate protections and security structures that are legally sound necessitates a holistic approach that considers the legal validity of each claim and potential conflicts across jurisdictions. The importance of coordination of local counsel – in particular, in respect of the appropriate governing law applicable to security perfection formalities – when setting up these structures is paramount to ensure robust and consistent protections for lenders, mitigating potential conflicts and maximizing enforceability across diverse legal landscapes.

Duarte Reis

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