LEGAL UPDATE[1]

By Tautvydas Medziukevicius

The "Legal Update" panel discussed latest updates surrounding market trends, regulation, fund terms and the LPA.

Global Trends

The fund finance market continues to grow at a high pace, particularly on NAV and more structured finance fund facilities. Subscription lines have been more commoditized, repetitive and intuitive. It is a proven technology that works for the funds and limited partners. There are more funds involved in the subline space including insurance funds, which means that there are more funded facilities and more term loan type structures that are permeating and persisting through most of the life of the fund creating, in some cases, more ratings requirements.

On the NAV side, it is becoming more interesting from a structural perspective. From a tax and legal perspective, the challenge is that investment funds are not necessarily constructed to accommodate a NAV facility. Legal, accounting and tax teams may have to engage in creative contortions to put facilities in place. With new generations of funds, the fund structures themselves are becoming a bit more accommodating. Preferred terms are being integrated into LPAs and fund structures set up so that there are no longer a multitude of equity HoldCos sitting above each asset that run into the MasterCo. There is now smarter technology to effectively do the same thing as before, compliant with the LPA, without creating unwanted tax implications.

The fundraising environment needs to be taken into context as it has been more challenging over the past couple of years. As a result, the Investor Relations teams are less receptive towards NAV facilities as they would like to change things as little as possible. They just want to focus on rolling over the same limited partners with minimal trouble and therefore NAV facilities may go on the back burner.

Fund Jurisdictions

Luxembourg remains the main fund jurisdiction because of its friendliness to investment funds and known structures and documentation.

[1] The panelists were Loïc Bacquelaine (Travers Smith LLP); Gabriela Patrikova (Linklaters LLP); Jad Nader (Ogier); and Roxana Mirica (Apax).

Luxembourg has been also very successful in last few years in terms of retailisation and establishing UCI part 2 funds. The success should be mostly attributed to the pragmatic regulator. Last year, the legislature in Luxembourg amended the law to bring more flexibility and to structure the part 2 fund as a partnership. By doing so, the legislature answered the questions from alternative investment fund managers whether those types of structures could be dedicated to retail. The possibility of using a partnership for a more traditional structure for alternative investment fund management will help UCI part 2 funds remain attractive.

Fund Documentation: NAV Financing Related Changes

The increase of NAV facilities for any type of fund has been a big topic. It is important to distinguish between different strategies because NAV facilities have been around for a long time for secondaries, credit funds or real estate funds. It is a bit newer in the private equity sector. However, PE documents are usually wired for NAV facilities as they are frequently silent on the type of financing permitted, while including terms that contemplate debt. A standard private equity LPA will typically have limits on borrowing, but those limits only capture borrowing at the fund level, whereas NAV financing will often be set up at a level below the fund.

LPAs do not cover NAV financing and any related disclosure because NAV facilities have not been a focus, and become relevant later in the fund's life, whereas fund documents are agreed at the beginning of the fundraising stage. Sponsors have taken different approaches to this. Some have taken the view that if the document is silent, it is not prohibited. Other sponsors have involved the investors in the discussions and even if they don't necessarily need consent, they will at least have some sort of consultation with their investor Advisory Committee.

So far, this tension has not led to many changes in the fund documents. This largely to do with the current market and the difficulty to raise financing. Historically, it took many years for funds to recognize the utility of addressing subscription financing in the LPAs, and to overcome their reluctance to ask LPs to make changes to the fund documents. In a time where GPs have less power, it is difficult to introduce significant changes. On the other hand, some investors may be nervous simply because the fund documents are silent on NAV financing, so they do not how, when and why NAV financing is going to be used.

One interesting development over the next month is going to be the release of guidance by Institutional Limited Partner Association (ILPA) on NAV Facilities. Transparency and education are predicted to be big topics in the guidance which will drive the discussion between limited partners and the investment funds on NAV financing.

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Fund Documentation: Subline Related Changes

The development of the subline market has led to higher caps compared to a few years ago and there have been smaller changes to make sure that the LPA works. Almost all LPAs will include an agreement by the LPs to fund capital calls without defence or counterclaim. The investors now accept this and no longer challenge it, although sovereign investors or international organisations (like the U.N.) have internal procedures and policies that may restrict their ability to agree to waive rights. However, an agreement to fund, while reserving rights against the GP and other LPs may often be accomplished, even if the LP has to get approval from senior management in their organisation.

AIFMD 2

Credit fund managers will be the most impacted by the new changes because of the new loan originating rules. AIFMD 2 will differentiate between funds which originate loans and loan originating funds. New rules will be on concentration limits, risk retention requirements, leverage limits and requirements to put in place policies to monitor and manage the credits and the assets of the funds.

Investment funds which do not originate loans to third parties may be within the scope of AIFMD 2 if they provide loans to entities within their capital structure. Many investment managers do so for internal structuring purposes. We will need to see how the directive is implemented in the member states to confirm this and how this will affect the shareholder exemption. Because of this a lot of the documents for the internal structure may need to be redrafted.

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