CADWALADER

FUND FINANCE FRIDAY

Winter and Sanctions are Coming

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Mine Your Dragonglass

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With President Trump announcing that both Winter *and Sanctions* are Coming full-on Game of Thrones-style, it is time to tune back in for the next season.

The November 5 reimposition of U.S. sanctions on Iran combined with the Khashoggi tragedy at the Saudi Arabia consulate in Istanbul has fund finance lenders asking about potential sanctions' impact on their portfolios. While the implementation of sanctions on a private equity fund investor raises a host of potential issues, here we highlight the impact for a lender's borrowing base.

Sanctions are not one size fits all. In the U.S., sanctions generally either target countries or regimes whose actions or policies are determined to constitute an unusual and extraordinary threat to the national security, foreign policy, or economy of the U.S., or target specific individuals or entities involved in or contributing to activity determined to constitute such a threat (such as narcotics trafficking, weapons proliferation, and terrorism). Currently, more than two dozen different sanctions programs are in place, most of which are administered by the U.S. Treasury Department's Office of Foreign Assets Control (known as "OFAC"). While many of the more longstanding sanctions were passed as law by Congress, more recently, sanctions have been more commonly imposed (and undone and then reimposed) by Executive Order. For those, the President has substantial flexibility in the specific terms dictated. Sanctions can be targeted at specific individuals, organizations, a government, an industry or industry sector or all residents of an entire nation state. Sanctions can vary in degree, from prohibiting any commerce at all, to prohibiting certain financial transactions, to only prohibiting military-related commerce. There can also be grandfathering, phase-in periods, and an exception approval (or "license") process. Thus, the impact of an investor becoming subject to sanctions, of course, depends on the specific terms of the actual sanctions implemented and the business or locale in which a fund invests.

If an investor were to become a "Sanctioned Person" or otherwise subject to a sanctions program that specifically and immediately prohibited all transactions and no exception or license were available, the fund likely would need to isolate that investor from the rest of the investor pool, cease making distributions, and cease accepting capital contributions from that investor. The fund would also be well-advised to seek immediate guidance from OFAC. In some subscription facilities, the fund's knowledge that an existing investor has become the subject of sanctions could be an event of default, requiring the lender and fund to agree to waive the event of default or otherwise resolve. In addition, under most subscription facilities, this would almost certainly trigger an exclusion event from the borrowing base.

Even where a particular facility does not expressly remove a sanctioned investor from a coverage ratio or the like, the lender and the borrower would likely need to come together to resolve. A lender may not be able to foreclose on a sanctioned investor's capital commitment without the lender itself potentially violating sanctions, and a lender cannot lend against uncalled capital which has become illegal to call. There is, of course, the additional potential that the lender has already advanced against the sanctioned investor's uncalled capital, in which the exclusion of such investor could create a borrowing base deficiency. In this circumstance, hopefully the lender's transaction structuring has included sufficient overcollateralization to permit the borrowing base deficiency to be repaid via overcalls on the remaining limited partners. The investment acquired with the related loan proceeds could provide another potential source of repayment as well. As we learned in Game of Thrones, a Lannister always pays his debts.

From a practical perspective, while we could see Cersei sanctioning the Dothraki in 2019, we think it unlikely that the U.S. would impose fund finance impactful sanctions on a sovereign wealth fund sponsored by Saudi Arabia. A sovereign wealth fund is distinguishable from both the nation itself and the individuals allegedly responsible for the horrific actions in Istanbul. The degree of commerce between the U.S. and Saudi Arabia, the benefits to the U.S. from foreign passive investments, and the need for allies in the Middle East all suggest that further sanctions, if any, arising out of the events in Istanbul would be highly targeted and unlikely to be broad enough to pick up a sovereign wealth fund's capital commitment to an unaffiliated fund. Additionally, the November 15 sanctions issued by OFAC targeted specific individuals allegedly involved in the Khashoggi murder, giving additional practical comfort that sanctions that could impact a subscription facility are not likely. We do not see a trial by combat with the Mountain for the fund finance markets this year.

In an upcoming edition, we will address the implications for the snap back of the Iranian sanctions.

Wells Syndication Conference Well Attended

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Wells Fargo's syndication team hosted its annual conference last week at the Plaza Hotel in New York. A large cross-section of the fund finance market attended. Jeff Johnston, Managing Director and Head of Subscription Finance at Wells Fargo, gave a unique and insightful state of the market presentation to the group. While acknowledging some headwinds, Johnston thinks continued meaningful market growth through 2019 is a reasonable presumption. One of the primary supporting factors is the continuing growth of private debt funds. Subscription facilities enable these funds to maintain a consistent leverage profile throughout the life of the fund, even at their inception prior to achieving sufficient asset diversification to enable asset-level financing. Some other insights and data points from the presentation:

- Johnston believes the biggest risk to a subscription lender is an investor revolt driven by a fraud allegation or other dispute with the GP;
- Clean-down requirements in fund partnership agreements de-risk transactions for the lender—they demonstrate that the investors are engaging with the GP over the terms of the subscription facility;
- Transaction "structural drift" in favor of fund borrowers, combined with new entrants being accommodative to funds to gain market entry, gives Johnston some pause; and
- Wells has 50 to 55 syndication partners participating in existing transactions and approximately 70 financial institutions in various stages of conversations involving participation opportunities.

When a Fund Isn't a Fund – "It's a Fund, Jim, But Not as We Know It"

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By George Pelling
Associate | Fund Finance

Traditionally, European fund vehicles have been established as limited partnerships with general and limited partners. Increasingly, fund clients and their lawyers are taking advantage of the variety of "fund" entities created over the last decade in Europe, resulting in an increase in corporate entities as fund vehicles.

These corporate vehicles, most commonly seen in the Irish and Luxembourg markets, do not have the usual GP/LP structure and instead, issue shares or other equity-like instruments when a capital call is made. Unlike a fund, which generally only requires the issuance of a call notice and the receipt of cash to complete an investor call, in the context of a corporate entity, additional steps may be required (such as the issuance of shares).

This has the potential to complicate enforcement of security over the right to call capital, either because the "fund" entity is insolvent and therefore prevented from issuing further shares or because the security agent is logistically unable to take the steps required (such as the issuance of shares) post-receipt of cash.

Depending on the type of entity being used as the fund vehicle, a variety of possible solutions present themselves. For example, the constitutional documents of the entity may provide for a deemed issuance of shares if capital is called for the purpose of enforcement, or there may be another mechanism to decouple the obligation of the investor to pay capital from that of the fund entity to issue shares. It may also be possible to have contractual arrangements in place with any entity that runs the administrative affairs of the fund entity, whereby they agree to issue the shares.

Issues relating to the corporate structure of the "fund" should be identified and discussed with lead and local counsel during the due diligence phase of a transaction, as the solutions may not be straightforward to implement.

Connecting the Dots

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By Chris van Heerden
Associate | Fund Finance

Banks expect to tighten lending standards should the Treasury curve invert next year, according to survey data released by the Federal Reserve on Tuesday. Curve inversion is not an idle concern since the Fed looks set to hike short-term rates three times next year (in addition to going in December), and the Treasury intends to meet a significant share of its nearly $1.5 trillion deficit funding need by issuing T-bills.

Consensus estimates have T-bill issuance increasing 30-40% in 2019 from what has already been a heavy 2018. Rate hikes plus heavy supply at the front end of the curve may push short-term rates up faster than longer term rates. In fact, looking at the forward curve, the market anticipates that the ten-year Treasury will yield only 6 bps more than the two-year by this time next year.

Regional banks may be handed a win in the proposed revised framework for prudential standards recently put forward by bank regulators. The two proposed rulemakings would particularly benefit firms with $100 to $250 billion in total assets. (See Cadwalader's *Rightsizing Regulation: U.S. Banking Agencies Release "Tailoring" Proposals and Regional Banks Are the Winners.)*

Loan demand from traditional bank borrowers continues to sag. The Fed's Senior Loan Officer Survey data released on Tuesday pointed to weakening loan demand in the commercial and industrial loan category, in residential mortgages, consumer debt, and across the board in commercial real estate.

Connecting the dots: We're lawyers, not research analysts, but we can easily envision a 2019 environment wherein banks gravitate to floating-rate assets because of the flat Treasury curve, and regional banks are ready to grow balance sheets but face weak loan demand from traditional commercial and industrial and real estate borrowers. That makes us optimistic about the outlook for subscription finance—a floating-rate product with robust new deal volume—and about the prospect of new lenders entering the space.

Hedge Fund Law Report Webinar

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On November 15, Thomas Draper, partner at Foley Hoag LLP, and Mike Mascia, partner at Cadwalader, joined Rorie Norton of the *Hedge Fund Law Report* for a webinar on the status of the fund finance markets. The webinar was a high-level overview of current market trends directed toward private equity and hedge fund finance department professionals. Topics covered included the benefits of subscription finance for a fund, addressing investors' interests in facility terms, essential provisions in a fund's partnership agreement and the evolution of transaction advance rates. Also covered was the convergence of committed capital structures into existing hedge funds and the challenges and benefits of lending to such hybrid fund vehicles. The webinar can be viewed here.

On the Move — Fund Finance Tidbits

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ING has appointed Fi Dinh as Director in FI-APAC, based in Singapore. Fi will focus on the origination and execution of investment industry finance and insurance finance products in the APAC region, reporting to the regional Head FI sector lending APAC. She joins ING from Barclays London, where she was Director, Private Equity and helped build a successful funds finance business in EMEA and the U.S. Fi sits on the committee of Women in Fund Finance, Europe and will continue this role in Asia. ING already has successful funds finance teams, being part of FI sector lending, in London and New York, and is expanding now to Asia.

Also in This Issue

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- These are busy days in sanctions. Look to the Cadwalader Cabinet for organized, curated, and useful information on the latest developments.
- On November 9, both *Reuters* and *Bloomberg* reported on a proposed $4 billion subscription facility being arranged for SoftBank's Vision Fund by Goldman Sachs and Mizuho. The *Reuters* article reports that a bank meeting occurred in London on November 8 and, interestingly, that key investors PIF and Mubadala attended the meeting in person. The two articles are available here and here.
- Maples and Calder this week announced the dates of the 2019 Maples Investment Funds Forum to be held in the Grand Cayman on February 8. Historically well-attended by the fund finance community, this year's forum has a great list of confirmed speakers. Information about the invitation-only event is available at www.maplesforum.com.
- A research paper published this week uses observed transaction prices for private equity investments to measure performance and volatility. Traditional fund performance measures rely heavily on data that only becomes available at final distribution. The authors construct a transactions-based index using secondary market data and compares this to performance as measured by Preqin reported NAV and the Burgiss index. The conclusions on fund investment volatility and cyclicality will be of particular interest to lenders involved in NAV-based facilities. A summary and link to the full report are both available here.
- Cadwalader advised the Structured Finance Industry Group (SFIG) in the involuntary chapter 11 petition filed against Taberna Preferred Funding IV, Ltd in June 2017 in the U.S. Bankruptcy Court for the Southern District of New York. After months of motion practice between the petitioning creditors and the parties opposing the involuntary petition, on November 8, Judge Vyskocil issued an opinion dismissing the petition. More on that here.

Got News?

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If you have a personnel update or job opening you would like to see featured in *Fund Finance Friday*, please email us at fund-finance-friday@cwt.com.

Happy Turkey Day!

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We will not publish *Fund Finance Friday* next week but will be back on November 30. We wish everyone a meaningful and enjoyable Thanksgiving.