CADWALADER

FUND FINANCE FRIDAY

Searching for Dragons to Slay

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Table of Contents:

The Rise and Rise of Public Pensions in Private Equity

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Two recent news items got me thinking about public pensions, their continued rise in private equity and their sovereign status. The first news item, already widely covered in the media, is the announcement by the Securities and Exchange Commission (SEC) of new rules requiring (among other things) enhanced periodic disclosure for fees, expenses and performance (including, possibly, reporting performance with and without the use of fund financing) (*see, e.g.,* "**The SEC's Private Market Takeover**" in *The Wall Street Journal*). *The Wall Street Journal*, in its unfavorable write-up, described the SEC as dancing "to the public pension tune," and *The Washington Post*, taking a more favorable view, noted that part of the motivation for the SEC is that "many retirees depend on the pensions that are invested in" private markets. (For *The Washington Post's* write-up, *see* "**SEC proposes basic rules for private equity, hedge funds**"). What's notable is both the media supporters and the media detractors have focused on public pensions. The media coverage therefore seems to imply that public pensions are partly driving this regulatory change.

I am not so sure, since that would be in conflict with the second news item, which is the increasing deployment of public pension money in private equity as a long-term secular trend. According to Prequin, the average public pension allocation has increased from just above 6% in 2010 to close to 9% in 2021. In percentage terms, that's a huge increase and a vote of confidence in private markets. (*See* "**Retirement Funds Bet Bigger on Private Equity**" in *The Wall Street Journal*). It's also worth remembering that these percentages are of massive holdings. Some of the biggest players have allocated an even larger exposure: the California Public Employees' Retirement System voted to increase its private equity allocation to 13% over the next four years, which equals roughly $25 billion dollars of additional demand from a single investor. With the increased demand from public pensions for private equity products, we have seen a greater internal focus on questions of sovereign immunity and its associated waivers at banks and sponsors. (I would also forecast an ever-increasing number of SMA facilities with public pensions, especially in the latter half of this year.)

What we can say for certain is that public pension money has confidence in private equity returns (now more than ever), but at least some voices in the media think that the current push for greater regulation and disclosure comes from those same investors. It's possible both of these statements are true, but it seems more likely that we need to be skeptical of the claim that public pensions are the source of the SEC's recently proposed rules. It is just as probable that the SEC was going to focus on private markets anyway, regardless of the actions or concerns of public pensions. Nonetheless, the greater exposure to sovereign-status public pensions and the greater focus on private market regulation are at least correlated. Both of these trends have been major stories of the past year, and each trend features sovereign-status public pensions as key actors.

In any case, there is some concern that increased public pension money may expose sponsors and funds to greater sovereign immunity risk and also that increased public pension participation in these markets may lead to greater regulation. The first concern, sovereign immunity, can be addressed succinctly: the exceptions and waivers to sovereign immunity which we see from many states and their agencies (*i.e.*, their public pensions) remain robust. The second concern, which is that the increased participation of public pensions in private equity is causing greater regulation, is likely unfounded based on the facts we can observe.

Two Sides of the Sovereign Coin

The current British sovereign gold coin features the face of Elizabeth II on the obverse (front) and St. George slaying his dragon on the reverse. It's the perfect embodiment of these two ideas: Elizabeth as sovereign looks serenely into the distance, but there is also the myth on the back: real or imagined dragons need slaying. (Certainly the proposed SEC rules are the sword, but I will let the reader decide who is St. George and who is the dragon.)

Side One: The Queen Can Do No Wrong

Fund Finance Friday has covered sovereign immunity before in detail. (*See* "**Immunity Unlikely**" by Wes Misson, which offers an excellent overview of the issue and the sponsor/lender protections available via various waivers.) The short version is that public pensions enjoy sovereign status under the Eleventh Amendment of the United States Constitution (though they are only one category of investors that may enjoy sovereign status, as foreign governments (or their agencies), supra-national organizations and Native American tribes may have sovereign rights in federal or state courts as well). However, the sovereign immunity of state public pensions is often waived when the state agency is entering into a commercial contract. This waiver may take the form of statutory or constitutional waivers (37 such states as of 2021) or common law waivers (12 such states as of 2021). In addition, we often see a public pension investor reserve its Eleventh Amendment status in a side letter, but will also have what lawyers call "mitigating language," which essentially states that the reservation of sovereign immunity does not in any way limit the investor's obligations to fund capital calls. Sovereign immunity is therefore often mitigated, and counsel perform careful due diligence to identify the risk and assess the mitigations available given the jurisdiction in question and the language in the side letter and limited partnership agreement. When such mitigants exist, the sovereign has a serene gaze indeed.

Side Two: St. George vs. the Dragon

Then there's the dragon, real or imagined. This is the media narrative that increased regulation of private markets is coming and that it's in part driven by public pension investors. It's easy for some in the media to make that connection − according to *The Wall Street Journal* article, public pensions count for 35% of all private equity capital, so it is tempting to connect the correlation of increased public pension money with increased regulation and to infer a causation. I would be skeptical of that claim. Pension funds have been and continue to be extraordinary partners with their private equity sponsors. The largest pension funds are not just investors, but co-investors, joint-venturers and some are even exploring the option of becoming liquidity providers to select sponsors.

Conclusion

We have often heard or read that “private markets are the new public markets.” A cynic could now say “private regulations are the new public regulations.” While the current composition of the SEC certainly suggests a greater role for regulation in private markets, it is not at all clear that these actions are a result of greater public pension participation. We should not blame public pensions for the political decisions of a select few in Washington. In fact, the increased allocations toward private equity suggest that the partnership between public pension investors and private equity sponsors is stronger than ever (for my part, my father’s public pension is tied up in many of the deals I work on, even though I typically represent the lenders). In addition, while many bankers/sponsors may receive increased internal scrutiny on sovereign immunity exposure to such investors, reputational risk and legal waivers mitigate this exposure into a manageable commercial risk (with some exceptions for certain problematic jurisdictions). Despite the proposed regulations, it’s not an exaggeration to say that the relationship between public money and private equity is now a cornerstone of the American economy. It’s a bit like a certain motto written on another English coin: *honi soit qui mal y pense*, or “shamed be whoever thinks ill of it.”

‘NAV’igating Cayman LP Interest Security – Lender FAQs

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As noted in our previous update, “‘NAV’igating Cayman Share Security – Lender FAQs,” fund finance lenders are increasingly encountering pledges of shares in SPVs incorporated in the Cayman Islands as part of the collateral package in NAV-based transactions. Another commonly seen aspect of such deals is a pledge of limited partnership interests (“LP Interests”) held by a borrower or other credit party (“Credit Party”) in one or more exempted limited partnerships formed in the Cayman Islands (“Cayman ELPs”). Such Cayman ELPs may be downstream holding or operating vehicles held by the Credit Party or interests it holds in funds managed by other sponsors. While security over LP Interests in Cayman ELPs is similar in some ways to taking security over shares of a Cayman company, there are some notable differences in legal requirements. This note aims to answer some of the most frequent questions that lenders ask in respect of security over LP Interests in Cayman ELPs.

Do we need a separate security agreement for the Cayman LP Interests?

There is no requirement from a Cayman perspective that security over LP Interests must be granted by an agreement governed by Cayman Islands law. In our experience, security over Cayman LP Interests which is granted as part of a fund finance transaction is most commonly documented under a New York law-governed security agreement that has been “Caymanized” to incorporate appropriate charging and security language and to otherwise address certain Cayman law issues (as further detailed below).

Are there any specific Cayman legal requirements in respect of taking security over LP Interests?

The Cayman Islands Exempted Limited Partnership Act (the “ELP Act”) has a number of specific requirements in respect of security over LP Interests. Most notably:

- The Cayman ELP must maintain a register of security interests detailing any security that has been granted over LP Interests;
- Unless otherwise specified in the LPA, a general partner must consent either prior to or simultaneously with the granting of security over LP Interests;
- Priority of a secured party’s security is obtained by either the holder of the LP Interest or the secured party serving valid notice on the registered office of the Cayman ELP of the

existence of the security. The notice must contain certain statutorily prescribed information to be valid (as set out in further detail below).

What type of diligence needs to be completed ahead of the grant of security?

As the core of the security will be the ability for the secured party to effectively have the LP Interests transferred to it or its nominee in an event of default, the LPA of the Cayman ELP will need to be carefully reviewed to establish what restrictions exist on the grant of security over LP Interests and the transfer of LP Interests – in particular, what consents are required from the general partner or other limited partners. Unlike security over shares in a Cayman company where the articles of association are commonly amended to incorporate lender-friendly language, it is in many cases more difficult to undertake this for Cayman ELPs. As such, consideration of any LPA issues that, though undesirable from a lender perspective, cannot be revised in that instance is an important issue in the diligence process.

In addition, the register of limited partnership interests and register of security interests of the Cayman ELP should be checked to verify the holdings of the Credit Party and that there are no presently existing security interests reflected over the LP Interests in question.

Is the security interest registered in the Cayman Islands or are any notices required?

The Cayman Islands does not have a central forum or legal framework for the granting or registration of security over LP Interests in a Cayman ELP. The ELP Act does, however, specifically provide that security granted over LP Interests shall have priority in accordance with the time when notice of such security is validly served on the registered office of the Cayman ELP in the Cayman Islands. In order for the notice to be validly served it must: (i) be in writing; (ii) be given by the grantor or grantee of the security; and (iii) specify the agreement pursuant to which the security is granted including the date, parties thereto (including the grantor and grantee) and the details of the part or whole of LP Interest secured. As a result of the ELP Act being specific as to these requirements, it is common for the credit agreement to incorporate an undertaking requiring the Credit Party to deliver the notice concurrently with closing and to evidence the delivery of the notice as soon as possible thereafter.

Are additional documents needed beyond the security agreement?

Irrespective of whether the security agreement in question is governed by U.S. or Cayman Islands law, certain ancillary documents are generally required to be delivered at closing to ensure the lender is in the best position to enforce its security upon default, most notably: (i) consent by the general partner of the Cayman ELP to the grant of security and an undertaking by the general partner that it will process a transfer of the LP Interest in an enforcement scenario; and (ii) a signed but undated LP Interest transfer form (together the “Cayman Security Deliverables”). It is also generally a requirement that the Credit Party deliver to the lender, post-closing, a copy of the register of security interests of the Cayman ELP updated to reflect the grant of security and, as discussed above, a copy of the notice to the registered office of the Cayman ELP.

How would we enforce the security in an event of default?

The security agreement will commonly provide the specifics of enforcement but, assuming the Cayman Security Deliverables have been obtained on closing, then enforcement of the security is usually a simple matter of executing the LP Interest transfer form provided on closing and delivering it to the registered office of the Cayman ELP, which will then update the register of limited partners and specify any other documents that the secured party may need to execute (such as a deed of adherence to the LPA).

Is stamp duty payable and at what rate?

Unless the security document is executed in or brought within the Cayman Islands, no stamp duty (or other Cayman Islands tax) is payable on the creation of the security interest.

If the Cayman ELP is registered as a Cayman Islands Mutual Fund or Private Fund, are any regulatory approvals required?

No prior regulatory approval (or post-closing notification) is required in respect of the granting of security over LP Interests of a Cayman ELP that is registered with the Cayman Islands Monetary Authority ("CIMA") as a mutual fund or private fund. CIMA approval is not required for enforcement of the security over an LP Interest or any resulting change of control of the entity.

Registration Opens for FFA European Symposium

March 18, 2022 | Issue No. 167

The Fund Finance Association this week opened registration for the 6th annual European Fund Finance Symposium, which will open with a Welcome Reception on the evening of June 27 and take place on June 28 at the Landmark Hotel in London. For more information or to register, click **here**.

WFF US Fireside Chat: Managing Teams Remotely

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Join WFF on Tuesday, March 22 for a Fireside Chat during which individuals from Macquarie Group will discuss the keys to engaging a hybrid team in the age of remote work. To register, please visit here.

WFF US: Wit & Wisdom Series Event

March 18, 2022 | Issue No. 167

WFF will host its first “Wit & Wisdom Series” event of 2022 on Thursday, March 31 in New York City on the topic of “Advocating for Yourself.” The series connects senior women in the fund finance industry with junior members for intimate breakfast discussions. For more info, please visit **here**.

Asia-Pacific Fund Structures and Market Update

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The NextGen APAC team will be hosting an April 7 panel discussing the use of HK and Singapore fund structures, in addition to current trends and a market update for the Asia-Pacific fund finance market. Click **here** for more information and to register for the event.

WFF Interview with Author Ilise S. Carter

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WFF US will host an April 7 Breakfast Event with Ilise S. Carter, author of “The Red Menace: How Lipstick Changed the Face of American History.” To register, click **here**.

'A New Asset Class Arrives' – The Drawdown

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The recent Fund Finance Association Symposium held in Miami marked the emergence of Fund Finance from a subset of private funds to an asset class in its own right. Read in *The Drawdown* about how the industry blossomed from a fringe private-capital player, the proliferation of new products and actors in the space and potential industry growing pains. Click **here** to read the article.

Fund Finance Hiring

March 18, 2022 | Issue No. 167

Fund Finance Hiring

Wells Fargo is hiring two Investment Banking Associates in New York, Los Angeles or Charlotte. For further info, please contact **Michele Simons**.