



FUND FINANCE FRIDAY

De-Risk and Deliver

October 14, 2022 | Issue No. 196

Table of Contents:

- [Risk Sharing – A Rising Trend](#)
- [From Russia with Sanctions – Cayman Introduces General Licence for Certain Funds](#)
- [FFA Diversity in Fund Finance NYC Event](#)
- [KBRA Recaps Recent Industry Events](#)
- [Article: ‘NAV Financing: A Terrific Tool for Savvy Fund Sponsors’](#)
- [FFA Alert on Scam Email](#)
- [Fund Finance Hiring](#)
- [Register Now for the 2022 Cadwalader Finance Forum | Oct. 27 | Charlotte](#)

Risk Sharing – A Rising Trend

October 14, 2022 | Issue No. 196



By Assia Damianova
Special Counsel | Securitization & Asset Based Finance



By Nathan Parker
Partner | Fund Finance

We are increasingly hearing from bank and non-bank lenders looking for ways to de-risk either all or, more usually, a portion of their exposure under a particular facility. It is perhaps a symptom of the current economic climate that these requests are becoming more frequent, particularly with respect to structured NAV trades.

Given this increased interest in the availability and typical operation of risk sharing arrangements, this week we are collaborating with Assia Damianova, a Special Counsel in our structured finance team who deals frequently with these products, to look at the options available to lenders in the European fund finance market.

Lenders look to share risk for a variety of reasons, which can include (i) credit risk mitigation, (ii) capital relief and (iii) compliance with internal policies relating to country limits, single obligor limits or corporate/sponsor group limits.

The aim of this note is to highlight that while the commercial effect of many risk sharing arrangements is similar, the legal and UK/EU regulatory view of the relevant instrument may be very different. This note does not intend to cover any capital relief issues for banks, which are a separate (and vast) area, but rather focuses on some of the key methods for de-risking with respect to a particular trade or obligor. The key methods of de-risking that we will discuss are participations (both funded and unfunded), guarantees and total return swaps, and we will also look briefly at how insurance considerations can be relevant to these products.

Participations

A participation can be used for a variety of reasons. For example, a participant may wish to obtain credit exposure to the performance of the borrower, while being unable to comply with the lender restrictions in the loan agreement, or wishing to achieve, vis-à-vis the lender of record, a different risk profile compared to that on the face of the loan (for example, a different interest rate floor, or a different duration of the exposure).

There are two types of participations.

Under a *funded participation*, the participant (the party gaining exposure without owning the loan) funds the grantor (the lender of record) so it can fulfil its obligations under the facility

when a loan is drawn.

The grantor passes to the participant the interest and principal, when received from the borrower, and pays a fee. The participant's return is conditional on the borrower complying with its payment obligations under the loan agreement and on the grantor complying with its payment obligations under the participation agreement.

Under a *risk participation*, the participant agrees to cover, up to a pre-agreed level, amounts that the grantor does not receive following a payment default under the loan agreement and, in return, the grantor pays a fee to the participant.

Legal Issues

English law-governed participation agreements are back-to-back funding arrangements that do not change the ownership of the underlying loan or the interest and other payments made under that loan. The participant assumes the double credit risk of a default by either the borrower or the lender of record. Indeed, the LMA produced a paper in 2010 called *Funded Participations – Mitigation of Grantor Credit Risk*, which provides trade parties with possible steps on how to mitigate the grantor credit risk.

Guarantees

Guarantees can also be used as a method of de-risking a trade. In the context of risk sharing, a third party guarantees performance by the borrower to the lender of record in return for a guarantee premium. There are a number of legal pitfalls when drafting guarantees: under English law, a guarantee is a secondary obligation in respect of the primary obligations of a third party (*i.e.*, the borrower) and is contingent on the validity and scope of the underlying guaranteed obligations. Consequently, there is a legal risk that a guarantee can be inadvertently discharged in certain circumstances, such as where amendments to the guaranteed obligation are made without the consent of the guarantor. There are also numerous other defences available to the guarantor that can vary in their strength and application depending on the circumstances.

Total Return Swaps (TRS)

Another option available to lenders of record to de-risk their position is a Total Return Swap (or TRS). Under a TRS contract, the total return payer agrees to pay the TRS receiver the “total return” on an underlying asset – in our case, a loan – while being paid interest returns from the other party – the total return receiver.

Through a TRS, the total return receiver (in our case, the party that comes in to share the risk): (a) receives interest payments on the underlying loan, plus any appreciation in the market value of the loan, and (b) pays interest (in the nature of a funding charge), plus an amount equal to any depreciation in the value of the loan. In other words, those payments, synthetically, approximate ownership of the asset.

The total return payer (in our case, the lender of record) buys protection against a possible decline in the value of the loan by agreeing to pay all the future positive returns of the loan to the TRS receiver, in exchange for floating streams of payments and the above-mentioned

depreciation in the loan value. In other words, those payments, synthetically, achieve credit protection in respect of the asset.

One of the benefits of a TRS is operational efficiency – for example, the total return receiver does not get involved in interest collections, payment calculations, and reporting that are required at the loan level, and neither does the total return receiver have to lay out substantial capital to purchase the loan.

Legal and Regulatory Issues

Unlike the participations discussed above, a TRS is a derivative and, therefore, it is a “financial instrument” under MiFID and activities relating to the TRS may therefore be “regulated activities” under MiFID requiring due authorisation (unless exemptions or exceptions apply). Separately, under EMIR^[1] (which has an extra-territorial reach), a TRS may, depending on the parties involved, be subject to a number of reporting and risk mitigation requirements, including the posting of regulatory margin.

Insurance – Different Interpretations

The boundaries between credit insurance, a participation agreement, a guarantee and TRS may get blurred, especially in bespoke and highly negotiated transactions. Therefore, courts or a regulator may interpret the arrangements differently than the contractual “label” attached by the parties.

For example, underwriting and brokering insurance contracts is a regulated activity under the Financial Services and Markets Act 2000, and the entity conducting such activities may need to be subject to prior authorisation by the PRA. Besides the issue of regulatory authorisation, contracts of insurance are subject to separate legal rules, both under statute and common law. One consequence of those is that an insurance provider would be able to assert a greater number of defences to payment. Separately, certain insurance products are subject to insurance premium tax.

English case law shows that certain types of contracts can be interpreted as either a contract of insurance or a contract of guarantee, and the court will look at the substance of the contract as a whole, without there being a single factor that can tip the arrangement into one category of agreement or another. Therefore, institutions should carefully consider all relevant features of the arrangement when structuring and drafting the de-risking instrument, and take appropriate legal advice. For example, and not as an exclusive list, some of the features of the risk sharing arrangement to consider are: (i) which party assumes the risk of profit and loss; (ii) does the party entitled to claim cover need to suffer actual loss, or could the loss be suffered by another member of the group; (iii) does the contract contain provisions consistent with insurance principles, including the duty of utmost good faith, (iv) is there a premium payable by reference to the probability of the occurrence of a loss; and (v) does the protected party have extensive disclosure obligations.

Facility Documentation Considerations

In the facility agreement itself, the main points for consideration for the lender of record and participant are (i) whether a de-risking transaction of the type contemplated is permitted under

the lender transfer provision of the facility and (ii) whether information sharing with the counterparty is permitted under the confidentiality provisions.

The lender transfer provisions are increasingly a point of focus in facility negotiations, with certain sponsors seeking to apply consent or consultation requirements for sub-participations generally or for sub-participations that transfer voting control. We have also seen some sponsors go further and seek to regulate the use of other de-leveraging products, such as those described above, through a variety of methods.

The LMA confidentiality provisions are also relevant, as the participant (and its counsel) will generally expect to be provided with the finance documents and may also require access to the documentation provided to the lenders through the periodic reporting under the facility. As with the transfer provisions, we are therefore seeing increased focus on the confidentiality provisions from sponsors and lenders alike.

Conclusion

Economically, different types of risk sharing instruments may produce similar results, but each product's legal, regulatory and tax analysis may differ significantly. Therefore, the structuring and legal documentation of risk sharing arrangements requires careful balancing of the tensions between each product, as well as sound-proofing against the risk of legal or regulatory re-characterisation.

[1] Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories.

From Russia with Sanctions – Cayman Introduces General Licence for Certain Funds

October 14, 2022 | Issue No. 196



By Derek Stenson
Partner | Conyers



By Michael O'Connor
Partner | Conyers



By Sarah Farquhar
Associate | Conyers

Russia's invasion of Ukraine has demonstrated again how interconnected the political and financial worlds have become. For those of us in the private equity and finance worlds, it has also given rise to associated challenges posed by the Russia-related financial sanctions that have followed. In the fund finance market, these issues have arisen both for sponsors (who are now faced with issues around freezing the assets of sanctioned investors without being able to remove them) and lenders (some of whom have been faced with credit parties to their facilities who now have sanctioned investors in their LP roster).

Unfortunately for us, there is no easy way to address these issues as the war, and sanctions issues, continue to rumble on.

In response to the sanctions and the associated problems that have arisen for investment funds that have sanctioned investors, the Governor of the Cayman Islands last week issued a General Licence (GL/2022/0001) in respect of "Designated Persons – Redemption/Withdrawal of investment, basic needs, routine holding and maintenance and payment of legal fees" (the General Licence).

Spoiler Alert: While most industry participants hoped that the General Licence would provide welcome solutions to issues with sanctioned minority investors in Cayman funds, this is unfortunately not the case for the reasons set out below.

What is the current position?

In short, where a fund has a sanctioned investor (which has been identified by the fund/fund manager itself or by its administrator as part of a periodic check of investors, which is more often the case) it must: (i) freeze the assets and funds of the sanctioned investor; (ii) report the issue to the Cayman Islands Financial Reporting Authority; and (iii) not take any action that could be considered to be "dealing" with the assets of the sanctioned investor, nor make any

funds or economic resources available to them. As the definition of “deals with” is very broad, it has led to a position whereby there are few, if any, actions a fund can take in respect of a sanctioned investor once it has frozen the assets – in particular, it cannot (without obtaining a licence, at least) redeem or involuntarily withdraw such an investor from the fund and place its assets in a blocked account or attempt to “sidepocket” the investor without potentially being seen to “deal” with the assets.

What permissions has the General Licence introduced and why does it not help with minority investors that are sanctioned?

The General Licence provides that a “Relevant Investment Fund” may redeem, withdraw or otherwise deal in an investment interest of a person that *is not* a designated person or owned/controlled by a designated person (a designated person being a sanctioned person).

A “Relevant Investment Fund” is defined as being an investment fund whose assets are frozen due to the investment fund being owned or controlled (*e.g.*, 50%+) directly or indirectly by a designated person. We understand that this segment of the market is so small as to be negligible and covers only a handful of funds.

Accordingly, the General Licence is not very helpful to the most frequent issue (minority holdings in a fund by a sanctioned person and the ability to remove that investor from a fund). Even if the definition did cover funds with minority investors, the permissions in the General Licence would not be of obvious use to most funds, as it provides for the redemption/withdrawal of non-sanctioned investors. This, of course, is the opposite of what industry participants had hoped for – being that the fund would now be able to redeem out the problem/sanctioned investor and freeze their assets, allowing the fund to continue on with the non-sanctioned investors.

It’s also important to note that any action to withdraw/redeem an investor is only permitted provided the actions are also permitted by the fund’s constitutional and contractual documents. The licence does not override the contractual position of the fund’s LPA.

Any fund wishing to rely upon the General Licence also needs to be mindful of other applicable sanctions regimes that it may be subject to.

Are there any additional general licences anticipated?

At present, the existing General Licence expires in April 2023 (unless revoked/suspended earlier by the Governor), and so any action that relevant funds wish to take must be ahead of this timeline. It isn’t yet clear if further general licences are to be expected and, if so, whether they would advance the position and allow for the redemptions/withdrawal and subsequent freezing of sanctioned investors from Cayman Islands funds.

FFA Diversity in Fund Finance NYC Event

October 14, 2022 | Issue No. 196



By Leah Edelboim
Special Counsel | Fund Finance

This week, Diversity in Fund Finance hosted its annual teach-in event for Baruch College undergraduates in New York. Bankers and lawyers from the fund finance industry attended the event (see the photos of our industry attendees below.) Natasha Puri of Lloyds Bank and Nick Mitra of SG Americas Securities, LLC gave a presentation on the fund finance market generally and the nuts and bolts of a subscription financing transaction.

The students are part of Baruch's [Financial Leadership Program](#), which is targeted to diverse high-performing juniors and seniors interested in careers in finance. Students must apply for acceptance to the program and take this on in addition to their course work in order to gain pre-professional training on technical, leadership, and professional skills. They have partnered with top firms that present on a wide array of topics ranging from financial modeling to mock interviews to presentation skills.

The event gave the students a unique opportunity to interact with different professionals in our market, get an idea of what different career paths might be, and gain exposure to a field that they may not have otherwise had the opportunity to learn about. The students asked insightful questions, making for a wonderful and highly interactive event.

If you would like to learn more and get involved with Diversity in Fund Finance, please reach out to [Natasha Puri](#).



KBRA Recaps Recent Industry Events

October 14, 2022 | Issue No. 196

In September, KBRA's Funds team attended Informa Connect's SuperReturn conferences for Private Equity, Energy and Private Credit in New York and Global Secondaries Summit in London.

For a recap of the U.S. Energy and Private Credit Conference, including insight into the state of the private credit market such as upward trends for club deals, and key discussion points on private equity in North America, click [here](#).

For a recap of the Global Secondaries Summit, including discussions on continued innovations in the market, fundraising trends and the macroeconomic environment, click [here](#).

Article: 'NAV Financing: A Terrific Tool for Savvy Fund Sponsors'

October 14, 2022 | Issue No. 196

Fund Finance Partners and Ropes & Gray have co-authored an article titled, "NAV Financing: A Terrific Tool for Savvy Fund Sponsors." The authors focus on NAV financing from the asset manager's perspective, including reasons for asset managers to use NAV financing and some of the top business and legal points for asset managers and their investment vehicles in NAV financing transactions. Read it [here](#).

FFA Alert on Scam Email

October 14, 2022 | Issue No. 196

Please be alert: the FFA announced this week that an unauthorized third-party company has reached out to FFA industry participants attempting to sell the APAC delegate list for financial gain. If you receive this email, please report it to your internal IT and security departments.

Fund Finance Hiring

October 14, 2022 | Issue No. 196

Fund Finance Hiring

Partners Group is looking to hire a fund financing professional in its Denver office – ideally someone with at least 10 years of relevant experience at a leading bank, asset management firm or law firm. This is an opportunity to contribute to Partners Group's growing fund financing platform by developing financing solutions for the firm's investment structures and funds, including subscription-backed credit facilities, bespoke investment-specific financing solutions, credit facilities for evergreen investment structures and implementation of letters of credit. If interested, please apply [here](#).

Register Now for the 2022 Cadwalader Finance Forum | Oct. 27 | Charlotte

October 14, 2022 | Issue No. 196



CADWALADER

FINANCE FORUM

CHARLOTTE

OCTOBER 27

The 2022 Cadwalader Finance Forum is just a few weeks away – on **Thursday, October 27** at the JW Marriott in Charlotte. We hope you can join us for what promises to be a very informative program featuring panelists from a broad range of preeminent financial institutions, investors, industry associations and other leading organizations. Following a keynote address from former NBA standout Muggsy Bogues, we'll hear from leaders from a range of organizations. For a list of speakers and topics and to register, visit [here](#).