CADWALADER

FUND FINANCE FRIDAY

Political Contributions and Navigating Capital Call Facilities

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Political Contributions Cease Funding Rights

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By Michael Mascia
Partner | Fund Finance

A handful of state pensions and other municipal investors in the United States have been including side letter provisions that prohibit principals or persons employed by a fund sponsor from making campaign contributions to a candidate whose elected position can influence the selection of the fund sponsor for investments. Quite similar to the more widely seen placement agent disclosure provisions, the remedy for a breach is often structured to give the municipal investor the right to cease funding capital contributions without being declared a defaulting investor. Not surprisingly, for a subscription lender, this is problematic. First, a lender is looking to underwrite the credit wherewithal of the investor to meet its funding obligations. Underwriting a fund's ability to prevent prohibited campaign contributions is more tenuous. Second, the allocation of risk could result in a windfall for the investor at the expense of the lender: an investment gets acquired on the subscription line and credited ratably to the investor's capital account, but the investor then ceases to be obligated to fund a capital contribution for the previously acquired investment? Often these issues are solved in practice with a tweak to the side letter obligating the investor to fund future capital contributions only to the extent there are amounts outstanding on the subscription facility. However, side letters often get to the lender consummated, and amendments after execution can be challenging.

Investors with political contribution cease funding rights are often just excluded from the borrowing base. But at times, the investor is needed to make the borrowing base for the facility viable. Lenders have on occasion gotten comfortable accepting this risk, rationalizing that if the sponsor has a robust policy prohibiting offending campaign contributions, a violation of the provision is not likely to happen in practice. I mean, it would frankly be awesome if my firm had a prohibition on campaign contributions wholesale, so there would be a built in excuse every time a law school classmate called about their upcoming school board campaign fundraiser.

Perhaps, however, the issue is not as factually hypothetical as it might seem at first. On December 18, 2018, the U.S. Securities and Exchange Commission issued an order in an administrative proceeding against an investment advisor for its alleged violation of Rule 206(4)-5 of the Advisers Act (the rule prohibits campaign contributions by certain investment advisor personnel to elected officials that can influence the selection of such advisor to manage the assets of government entities and public pension plans). According to the order, personnel at the advisor made campaign contributions to candidates for the offices of governor and treasurer of the State of Ohio. The governor and the treasurer of Ohio each appoint at least one member of the board of the State's public pension system, which makes investment selections. The advisor allegedly was managing investments for the pension system during this time period. Without admitting or denying the allegations, the advisor settled the matter and paid a civil penalty. The advisor was not a small shop; it reportedly had assets under management at the time on the order of $4.6 billion. Thus, it appears the exact facts that could trigger a cease funding right have allegedly occurred. There is no interplay with a subscription facility in the order, a copy of which is publicly available here.

Navigating Capital Call Facilities

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By George Pelling
Associate | Fund Finance

When the fund finance market began to develop in the UK in the early 2000s, it was not uncommon for standard capital call facilities to include various financial covenants regarding the performance of the underlying assets of the fund, including net asset value (“NAV”) and loan-to-value (“LTV”) tests. Since then, the fund finance market has rapidly evolved, moving away from the use of these provisions in “pure” capital call facilities in favour of their inclusion in genuine hybrid or asset-backed fund finance deals.

Despite this, recent developments in the private equity market have given lenders pause. Increasingly, lenders under standard capital call facilities are placing greater importance on the underlying assets of the fund.

It goes without saying that financial institutions providing capital call facilities will be primarily focused on the uncalled commitments of the investors; for standard subscription lines, the uncalled commitments are the bank’s primary source of repayment. The value applied to the uncalled capital by the bank (whether using a borrowing base or coverage model) will therefore determine the amount such lender will make available to the borrower under the facility. That said, subscription line lenders’ interests are not confined solely to the uncalled capital commitments of a fund, and the importance of the underlying assets should not be underestimated.

There are various reasons for this. A fundamental one is that, even where a lender has no security over the fund’s underlying assets, they may still be available to the lender in an enforcement scenario (notwithstanding that a lender under a standard capital call facility will only be able to make a claim against the underlying assets of the fund on an unsecured basis and will most likely be subordinated to the claims of any asset-backed lender(s) of the fund). Putting the complexities of enforcement to one side, however, it is possible that the assets of the fund may provide additional recourse to a lender if it is unable to recover its debts via its security package (i.e., from the investors and any amounts held in a secured account).

Another important factor for lenders to consider is the impact that the performance of the underlying assets has on investor behaviour. If an investor’s perception of its obligations to the fund is that it is “throwing good money after bad,” it may seek to avoid or renege on its commitment to provide further capital. Conversely, where an investor is aware the fund has valuable “assets in the ground,” the investor has a far greater incentive to comply with its contractual obligations under the fund documents. Of course, none of this is to suggest that any investor will have any legal right to avoid honouring its contractual commitments, but it is clearly preferable for a lender to try avoid any such scenario occurring altogether.

NAV and asset coverage tests can certainly give comfort to lenders, but they are not the only solution available in the subscription line market. There are a range of additional contractual protections that can be included in a capital call facility in order to address concerns regarding investor behaviour and/or the performance of a fund’s underlying assets.

Fund Finance Recruiting Firm Brickfield Recruitment Launches

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Brickfield Recruitment, an executive search and recruiting firm focused exclusively on the Fund Finance market, announced its formal launch this week. Brickfield intends to match candidates with law firms and financial institutions, covering both banking and legal professionals in Fund Finance. The firm will be headquartered in London. More information about Brickfield is available at www.brickfieldrecruitment.com

Fund Finance Helps Secondaries Start 2019 with a Bang

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Secondary funds are using leverage at record rates, according to a report published by Triago that was highlighted in a recent *Secondaries Investor* article. Because leverage can smooth the traditional cycle of secondary volume, secondaries utilized leverage in 38% of deals by total transaction value in 2018, up from 23% in 2017. Despite a downturn in public markets at the end of 2018, leverage was a significant factor in secondaries deal volume being at $6.3 billion in January and on pace to smash the $13 billion volume mark set in Q1 2018. Yet some prognosticators have concerns that GP-led deals with substantial leverage could suffer if there were a recession. The full *Secondaries Investor* article is available by subscription here.

Fund Finance Hiring

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Fund Finance Hiring

Credit Suisse Seeks Fund Finance Attorney

- Credit Suisse seeks a Fund Finance Attorney to join the fund-linked products team in its New York office. The job posting is available here. This is a transactional position, focused on drafting and negotiating secured credit agreements for financing transactions collateralized by hedge fund portfolios, private equity fund portfolios, or fund investor uncalled capital commitments.

Fund Finance Calendar

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Fund Finance Calendar

Upcoming Events in Fund Finance

March 24-26, 2019	9th Annual Global Fund Finance Symposium, Fontainebleau, Miami Beach, Florida
June 20, 2019	5th Annual European Fund Finance Symposium, The Landmark, London
September 24, 2019	3rd Annual Asia-Pacific Fund Finance Symposium, Four Seasons Hotel, Hong Kong
October 17, 2019	Cadwalader Finance Forum, The Ritz-Carlton, Charlotte, North Carolina

If you have an event that you would like listed on the *Fund Finance Friday* calendar, please email us at fund-finance-friday@cwt.com.