CADWALADER

A Fresh Look at Side Letters

June 7, 2024

By Nathan Parker
Partner | Fund Finance

Side letters have gone through a massive and largely unspoken transition over the last 4 to 5 years. From a position where a few investors in a closing might have quite short side letters dealing with niche issues we are now at a point where it is not uncommon to see the vast majority of investors in a closing have the benefit of negotiated side letter protections in side letters that can extend to upwards of 20-30 pages.

Most, if not all lenders will require a review of side letters when entering into a subscription financing but they are also relevant for other fund financing products. And, in the context of a traditional subscription facility, the increased sophistication of side letter provisions means that there are always new considerations for lenders to weigh up.

GP support facilities

When reviewing side letters for the purposes of a GP support facility the main focus will be on provisions that relate to the management or GP profit fee. These provisions can not only adjust the level of the fee payable by a particular limited partner but, perhaps as a symptom of the constrained fund raising market, might also extend to payment holidays for an initial period in the fund's life or may offer a discount not only on the investment in the fund to which the side letter relates but also later as yet unformed vintages.

Another aspect that may be present are restrictions on overcalls when the default of another limited partner in meeting its payment obligations under a capital call relates to a call made to fund management fees. Such a provision is clearly of relevance to a facility that is backed by the management fees but is also of relevance to a subscription facility that allows within its purpose clause an ability to draw under the facility to fund payment of the management fee. Depending on the prevalence of such overcall restrictions in the side letters of a fund it may be advisable for a subscription facility lender to either prohibit the use of the facility for the purpose of paying management fees or only allow such drawings for a short tenor that expires before the next instalment of the management fee is due under the LPA.

NAV financings

We are hearing from a lot of market participants at the moment asking whether or not we are seeing a change in LPA terms as a result of the increased focus on NAV style leverage. Part of the answer to that question actually lies within the side letters themselves and it is perhaps symptomatic of the side-lined position of the side letter in some people's minds that the question does not generally extend beyond the LPA. Given the precedent nature of LPA documentation it is far more likely that a sponsor will agree to a bespoke adjustment to its ability to incur leverage in a side letter than to imbed it in an LPA that will form a template for later vintages.

A side letter review is always advisable when contemplating a NAV financing and, if not feasible for cost or other reasons, then a clear representation should be given as to no conflict with fund documents including the side letters.

We have seen recent instances of sponsors agreeing in side letters to notify particular investors of potential NAV financings and to provide periodic reporting with respect to that financing once it is in place.

We have also seen instances of sponsors acknowledging that the investor has an interest in participating in a NAV style financing.

Subscription facilities

As mentioned above, most lenders in subscription facilities routinely require that side letters be the subject of a due diligence report. Such a report will typically look at matters such as cease funding rights, overcall limitations, sovereign immunity, excuse rights and other matters relevant to the ability to call capital and enforce default rights against an investor.

Some other matters are now either becoming increasingly common place in side letters or are starting to appear for the first time.

One example of a provision that is appearing for the first time is an ability for an investor in a politically sensitive jurisdiction to transfer its LP interest to another person without GP consent if that jurisdiction or investor becomes the subject of sanctions.

Another provision, which although not new, is becoming increasingly prevalent is a requirement for capital call notices to be signed by a person at the GP that has provided a specimen signature through an incumbency certificate issued by the GP. Although there are potential solutions to this in the context of a financing, the need for a specimen signature has the potential to be problematic if the security agent is issuing the capital call notice on enforcement.

We have also seen an increase in the number of investors whose stated commitment under the subscription agreement is actually reduced in the side letter in such a way that it will ratchet up to the full amount specified under the subscription agreement with each close and only actually reach the full amount if the fund-raise reaches its projected amount. Care must be taken here to properly record the actual amount (rather than the stated amount) for the purposes of calculating the borrowing base or financial covenant and to only increase that amount once evidence is received (generally in Europe by way of an updated LP register) that an increase has occurred. Given the subscription and side letter due diligence reports are often separate it is important that the ratchet mechanic be reflected in both to avoid any misstep.

In the subscription facility context, and as side letters become more complicated and investor requirements more bespoke, it is hoped that fund counsel will be mindful of the position of lenders and negotiate exceptions to provisions that are problematic from a financing perspective for lenders that are making capital calls on enforcement to avoid the need to exclude investors from the included investor pool.

Fifth Circuit Strikes Down the Private Fund Adviser Rules

June 7, 2024

By Leah Edelboim
Partner | Fund Finance

This week, the U.S. Court of Appeals for the Fifth Circuit vacated the private fund advisor rules (the "Final Rule") adopted by the United States Securities Exchange Commission (the "SEC"). The Final Rule imposed significant regulatory requirements on advisor to private equity funds, hedge funds, and other private funds. It represented a significant expansion of the SEC's power to regulate private fund advisor and investors and, according to the decision, compliance with the Final Rule would cost the private funds market $5.4 billion and require millions of hours of employee time.

The Court vacated the Final Rule in its entirety. In a unanimous decision with Judge Kurt Englehardt writing for the three-judge panel, the Court concluded that, in enacting these rules, "The Commission has exceeded its statutory authority. No part of it can stand."

The Court's decision emphasizes that, if reform such as this is going to be implemented by an organization like the SEC, which is part of the executive branch, it needs to be done within the bounds of the laws that give such organization the power to regulate. The SEC was established pursuant to the Securities Exchange Act of 1934 and is led by a five-member Commission. The Commissioners are appointed by the President, not elected, and are confirmed by the Senate. The President also decides which of the five Commissioners will be the SEC Chairman.

The Final Rule was comprised of a number of separate rules intended to govern the $26 trillion private funds market, including:

- Preferential Treatment Rule – a rule that limited the ability of fund sponsors to grant certain investors better terms than other investors, such as more favorable redemption terms, greater access to information, or just better or different treatment - fund finance industry participants understand from side letter diligence that the granting of preferential terms can be an important element of the investing relationship particular investors have with a fund.
- Restricted Activities Rule – a rule that placed restrictions on the charging of certain fees or expenses, and disclosures regarding the same.
- Quarterly Statement Rule – a rule that required that private funds advisors provide their investors with detailed quarterly reporting which would include fund performance as well as expense reports. This rule was particularly relevant to subscription lending, as it required funds to disclose unlevered returns without the impact of fund-level subscription facilities. The SEC has expressed concerns that levered returns don't provide a complete picture of fund performance.
- Advisor-led Secondaries – a rule that required advisors to obtain and distribute to investors an independent fairness or valuation legal opinion in connection with certain types of transactions.

The plaintiffs in the case who challenged the Final Rule included the National Association of Private Fund Managers, the Alterative Investment Management Association, the American Investment Counsel, the Loan Syndications and Trading Association, the Managed Fund Association and the National Venture Capital Association. They have been some of the loudest voices opposing these regulatory measures since they were initially proposed by the SEC in February 2022.

As further background, on August 23, 2023, the SEC's five Commissioners voted 3 to 2 to adopt the Final Rule. In promulgating the Final Rule, the SEC relied on certain anti-fraud rulemaking authority under the Investment Advisers Act of 1940, as well as the Dodd-Frank Act. The SEC adopted the Final Rule despite the questions raised by some experts and commentators as to whether it had the statutory authority to do so.

Just a week later, on September 1, 2023 the plaintiffs in this action filed a petition with the Fifth Circuit Court of Appeals seeking review of the Final Rule under the Administrative Procedure Act (the "APA") claiming that, among other things, the SEC did not have the authority to institute such significant regulation that "would fundamentally change the way private funds are regulated in America." The APA sets forth a high standard for overturning a decision by a regulatory authority like the SEC whereby a court must uphold a decision unless it is in "excess of statutory jurisdiction, authority, or limitations" or "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law."

The Court considered the powers that the relevant laws give the SEC to regulate funds and investment activities and determined that the SEC exceeded the power it has under the relevant laws when it adopted the Final Rule. Under the APA, the Court found it to be against the law and vacated it – meaning, set it aside.

As a bit of a kicker the Court found the SEC's position that the Final Rule is to prevent fraud as "pretextual" and that the SEC had failed to articulate a "rational connection" between fraud and any part of the Final Rule.

We will continue to monitor this case for any further developments and will post any updates here in *Fund Finance Friday*. The SEC has not indicated what it is going to do next, if anything. Of course it could abandon these efforts completely. If the SEC decides to appeal, it could request a hearing *en banc* by the full Fifth Circuit or it could attempt to appeal to the Supreme Court.

The takeaways for fund managers are that if the Fifth Circuit's decision vacating the Final Rule is not set aside by the full Fifth Circuit Court of Appeals or if the Supreme Court does not overrule this decision (or if it declines to hear it all together – it only hears about a hundred out of thousands of cases that petition to be heard), then the Final Rule will never take effect.

DFF: Suits & Soju - Second Annual Summer Soiree

June 7, 2024

The Diversity in Fund Finance Committee is excited to invite you to the Second Annual Summer Soiree: Suits & Soju!

Join us for an evening of networking and Korean tapas at Baro by Chefs Society where we will share the story behind owner Seolbin Park opening her popular Korean gastropub and weathering the challenges faced by many small businesses during COVID.

In recognition of Pride month, we will be holding a raffle to benefit The Trevor Project, with prizes and more! The Trevor Project is the leading suicide prevention and crisis intervention nonprofit organization for LGBTQ+ young people.

Come celebrate Korean culture and support a fantastic minority small business owner while benefiting our DFF community.

BARO means 바로 in Korean translating to “Do It Right” - so don’t miss out!

Space is limited; please confirm your spot **here**!

Event Details:

Location: Baro by Chefs Society - 23 W 31st St, New York

Date: Wednesday, June 26th, 2024

Time: 6:00PM – 9:00PM EDT

Register Now: WFF Americas Toronto

June 7, 2024

Register to save your spot for an evening of networking with your fellow industry participants. The event includes a panel discussion spanning industry viewpoints, all while enjoying light beverages and bites.

This event is open to all genders and current & prospective members of Women in Fund Finance, the Fund Finance Association, Diversity in Fund Finance and NextGen.

We hope you will be able to join us for what promises to be a wonderful evening!

Event Details:

Location: CIBC Square 49th floor (81 Bay Street, Toronto, Ontario M5J 1E6)

Date: Thursday, June 27th, 2024

Time: 5:00PM - 7:30PM EDT (doors open at 5:00pm, panel starts promptly at 5:30pm, followed by reception)

Contact **info@womeninfundfinance.com** if you have any questions

Register **here**.

Fund Finance Tidbits – On the Move

June 7, 2024

Congratulations to the following individual(s) who are on the move in Fund Finance:

There are a number of new joiners to the growing Huntington National Bank fund finance team. Congratulations to **Erin Coveny** who has joined as Senior Vice President/Regional Credit Officer in New York. In making this move, Erin is reunited with ten members of the Signature fund banking team that are now on team Huntington.

We also wish a hearty congratulations to **Ramiro Rodriguez**, who has joined the Fund Finance group at Huntington National Bank as a Senior Associate, and to **Rae Gutcheon** who has joined the group as an Associate, both in Charlotte.

The Huntington Fund Finance business, led by well-known fund finance banker Brad Boland, now constitutes a team of 13.

Congratulations to Erin, Ramiro and Rae!

Fund Finance Hiring

June 7, 2024

Fund Finance Hiring

Here is who's hiring in Fund Finance:

Cadwalader's Fund Finance group is currently interviewing staff attorney candidates in our Charlotte, NC, and New York, NY, offices. These positions are great opportunities for recent law school graduates to join a growing and dynamic Fund Finance practice, and for more senior attorneys with unrelated legal experience to transition into Fund Finance. Interested candidates can apply directly **via this link**. Please contact Sarah Breen at **sarah.breen@cwt.com** with any questions.

KBRA (Kroll Bond Ratings Agency, LLC) is seeking an experienced attorney to join the Ratings Legal team, in support of the Funds and ABS units. Position can be based in New York or Chicago. Interested candidates can find more information **here**.