

FINANCING FACILITIES

HFLR Program Provides Overview of Five Financing Options Available to Private Funds (Part One of Two)

By Vincent Pitaro, *The Hedge Fund Law Report*

Depending on the nature of their operations, strategies and investments, private fund managers have access to a number of different sources of financing. A recent webinar presented by The Hedge Fund Law Report provided an overview of the following types of financing arrangements used by private funds: total return swap (TRS) financing, structured repurchase agreements (repos), prime broker (PB) financing, special purpose vehicle (SPV) financing and subscription credit facilities. The program, entitled “An Introduction to Fund Finance Structures,” was moderated by Kara Bingham, Associate Editor of The Hedge Fund Law Report, and featured [Fabien Carruzzo](#), partner at Kramer Levin; [Matthew K. Kerfoot](#), partner at Dechert; and Jeff Johnston, managing director at Wells Fargo Securities, LLC.

This article, the first in a two-part series, explores basic principles of financing arrangements and provides an overview of PB financing and TRS financing. The [second article](#) will provide an in-depth discussion of structured repos, SPV financing and subscription credit facilities.

See “[Types, Terms and Negotiation Points of Short- and Long-Term Financing Available to Hedge Fund Managers](#)” (Mar. 16, 2017).

The Basics of Fund Finance

A basic principle of any asset-based financing arrangement is that the lender wants to be able to foreclose on its collateral without delay in the event of the borrower’s default, Carruzzo began. Some of the assets that private fund managers are seeking to finance include those that are illiquid, esoteric, volatile or otherwise difficult to value, all of which increase a lender’s risk.

There are two primary reasons that could delay a lender’s ability to foreclose on the collateral. First, when a fund files for bankruptcy, the lender may be subject to the automatic stay under the U.S. Bankruptcy Code and will need permission from the court in order to take any action against the fund’s assets. Additionally, a lender could be subject to the foreclosure rules under the Uniform Commercial Code (UCC), which could delay foreclosure by weeks or months, thereby putting the collateral

at additional risk. To mitigate these risks to the lender, certain financing structures have been developed.

With synthetic structures like TRS and repos, the lender holds title to the assets, which obviates the need to follow UCC foreclosure rules, Carruzzo continued. In addition, these structures are covered by safe harbors under the U.S. Bankruptcy Code that permit the lender to terminate these transactions without being subject to the automatic stay provisions. The downside to the fund of these structures, however, is that the fund manager frequently loses some control over the assets, voting rights and the ability to manage the assets.

PB and SPV financing are more conventional in the sense that the lender secures the financing through a lien over the borrower’s assets. With SPV financing, the SPV is structured as a bankruptcy-remote entity, thereby allowing the lender to foreclose on the collateral held in the SPV in the event of the fund’s bankruptcy. In the case of PB financing, the PB has the benefit of the [securities contract safe harbor](#) under the U.S. Bankruptcy Code and therefore should be able to avoid the automatic stay. There are also fewer UCC-related concerns with PB financing due to the fact that PBs often finance more marketable securities, which can be foreclosed on quickly.

PB Financing

Key Features of PB Financing

PB financing is the most common form of private fund financing, especially for long/short managers, Kerfoot said. It is typically a secured, short-term facility that is callable on demand by the PB. The PB may also allow the fund to purchase securities on margin and engage in short selling. The PB typically retains the right to increase margin or interest rates at any time, which can have the same effect as calling back the financing. Some managers may be able to negotiate a 90- or 180-day lockup agreement with the PB, thereby locking in the financing arrangements for a period of time.

The PB holds the fund's accounts as collateral and can re-hypothecate the securities in those accounts and raise additional capital against those assets. This form of financing has traditionally been available for liquid securities, including publicly traded equities and bonds. It is generally not available for illiquid assets like private debt or middle-market loans.

See "[SEC Charges Broker-Dealer With Numerous Violations of Customer Protection, Hypothecation and Reporting Rules](#)" (May 3, 2018).

Key Negotiation Points in PB Financing Arrangements

PB agreements have standard contractual covenants, events of default and representations and warranties, Kerfoot continued. Fund managers typically negotiate the events of default, despite the fact that the facility is callable. The PB arrangement will usually secure all obligations that a fund may have under any agreement with the PB or any of its worldwide affiliates, Carruzzo added. Therefore, any fund assets held by those affiliates will also secure the fund's obligations under the PB agreement. Consequently, a manager may wish to try to "silo" assets that it does not want to be subject to the PB agreement.

The PB agreement may override other agreements between the fund and the PB, such as a TRS, which may have more favorable terms from the fund's perspective, Carruzzo said. A PB agreement can be the weak link in the relationship, because it can "taint" other fund agreements with the PB.

For funds that enter into a lock-up arrangement with the PB, the fund manager should closely review the valuation provisions, particularly if the fund is seeking to finance less liquid assets. Finally, if the PB re-hypothecates the fund's assets to source the financing it extends to the fund, the fund manager should ensure that the PB is required to return those assets to the fund when needed.

See our three-part series on mitigating prime broker risk: "[Preliminary Considerations When Selecting Firms and Brokerage Arrangements](#)" (Dec. 1, 2016); "[Structural Considerations of Multi-Prime or Split Custodian-Broker Arrangements](#)" (Dec. 8, 2016); and "[Legal Considerations When Negotiating Prime Brokerage Agreements](#)" (Dec. 15, 2016).

TRS Financing

Key Features of a TRS Financing Facility

A TRS is a derivative contract between a fund and a dealer/lender, Carruzzo explained. The parties designate the assets that they desire to finance via the swap. Income generated by the assets is paid by the dealer to the fund. At maturity, any increase in the value of the assets is paid by the dealer to the fund, and any decrease in value is paid by the fund to the dealer. Although not required to do so, as a hedge, the dealer often purchases the reference assets from the fund or from a source in the market identified by the fund. The fund pays the dealer initial margin and a finance charge on the dealer's cost of purchasing the assets. The fund also pays variation margin during the life of the TRS.

For more on variation margin, see "[Steps Hedge Fund Managers Should Take Now to Ensure Their Swap Trading Continues Uninterrupted When New Regulation Takes Effect March 1, 2017](#)" (Feb. 9, 2017).

See also "[Three Asset-Based Financing Options for Private Funds: Total Return Swaps, Structured Repos and SPV Financing \(Part One of Two\)](#)" (Apr. 5, 2018).

Key Negotiation Points in TRS Financing Documentation

A TRS is typically documented through the standard International Swaps and Derivatives Association (ISDA) documentation, as well as a long-form confirmation, which is often 40 to 60 pages in length that is similar to a credit agreement, according to Kerfoot. As in credit agreements, the confirmation will likely include financial ratios, leverage ratios and opinion requirements.

Common points of negotiation, Kerfoot explained, include:

- Structuring Security-Based Swaps: A single TRS on a pool of assets is a swap for CFTC purposes, which may cause the fund to be deemed a commodity pool. To avoid this issue, industry practice is to create a "master portfolio" with a TRS for each individual asset. Each swap in the master portfolio is considered a security-based swap that is subject only to SEC jurisdiction. See "[How Have Dodd-Frank and European Union Derivatives Trading Reforms Impacted Hedge Fund Managers That Trade Swaps?](#)" (Oct. 17, 2013).

- **Ability to Substitute Assets:** A TRS is typically a committed facility for which the fund pays a fee. Consequently, fund managers often negotiate whether and when the dealer has the ability to reject an asset that the manager wants to add to the pool of assets being financed.
- **Accrual of Financing Charges:** The finance charge on a TRS is typically LIBOR plus a spread. Dealers frequently want the finance charge to accrue as of the trade date, despite the fact that the trade may not settle for up to two weeks. See [“How Hedge Fund Managers Can Prepare for the Anticipated ‘End’ of LIBOR”](#) (Aug. 24, 2017).
- **Retention of Voting Rights:** Some managers want to retain voting rights, especially in connection with commercial real estate and distressed assets. Doing so may make the TRS look more like a credit agreement.
- **Tax Treatment:** Fund managers must consider the tax treatment of assets held by the dealer. The transaction could be subject to withholding or other adverse consequences. Additionally, the fund will usually want to treat the TRS as debt for tax purposes, thereby allowing the fund to deduct the floating payment amounts. There is a way to structure these facilities to allow the fund to receive this tax treatment, while retaining many of the other beneficial aspects of the TRS structure. See [“Tax Practitioners Discuss Taxation of Options and Swaps and Impact of Proposed IRS Regulations”](#) (Feb. 19, 2015).

Lender Concerns

A dealer’s key concern when deciding whether to provide TRS financing is the identity of the borrower and its experience around the underlying collateral, Johnston said. It may be concerned about a potential borrower that is a “tourist” in the relevant market. A dealer devotes significant resources to conducting legal due diligence to ensure that it can access collateral in the event of a default. It considers market volatility, market depth and the risk that the market for an asset will dry up during the life of the contract, as well as fundamentals and long-term cash flow.

Advantages of TRS Financing

TRS financing facilities offer a number of advantages over other asset-based facilities, Carruzzo explained:

- **Bankruptcy Safe Harbor:** A dealer can terminate and unwind a TRS “on a moment’s notice” and liquidate the collateral, which allows the dealer to offer better terms to the fund. The

fund benefits from the same safe harbor in the event of the dealer’s bankruptcy, but its initial margin may be at risk if it is not properly segregated.

- **Cost-Effective:** TRS have “lean documentation” based on the ISDA Master Agreement, which makes them cost-effective. Credit approval may also be easier if the fund already has an ISDA with the dealer. Market participants usually can rely on preexisting industry legal opinions.
- **TRS Are “Reusable”:** The ISDA Master Agreement can be kept alive and reactivated from time to time by adding additional assets via a supplement to the confirmation.
- **Outsourced Administration:** The fund can outsource to the dealer the purchase, sale and other administration of assets.
- **Payment Netting:** Payments under a TRS can be netted. Therefore, the fund only has to make a single payment on a monthly or quarterly basis.
- **Access to Restricted Assets:** TRS enable funds to gain exposure to assets that can only be held by certain holders. The dealer is the record holder, but the fund has beneficial ownership of the economics.
- **Tax:** Funds achieve certain tax advantages when holding assets under a TRS instead of outright.

On the other hand, a TRS prevents the fund from exercising full control over the assets because the assets are owned by the lender, Carruzzo cautioned. Funds may try to negotiate voting and information rights, but lenders are reluctant to grant these rights due to the risk of recharacterization as a secured loan. In addition, it may be difficult for the fund to regain the assets at the termination of the swap.

For more on ISDA documentation, see our three-part series “Best Practices for Fund Managers When Entering Into ISDAs”: [Negotiation Process and Tactics](#) (Jan. 12, 2017); [Negotiating Event of Default and Termination Event Provisions](#) (Jan. 19, 2017); and [Negotiating Collateral Arrangements](#) (Jan. 26, 2017). See also [“In a Total Return Swap to Which a Hedge Fund Is a Party, Which Governs: The ISDA Master Confirmation or the Credit Support Annex?”](#) (Nov. 8, 2013).

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As some private fund managers have looked to finance illiquid and esoteric assets, lenders have developed financing structures that go beyond the more traditional forms of prime broker (PB) financing and secured loans. A recent webinar presented by The Hedge Fund Law Report provided an overview of the following types of financing arrangements used by private funds: total return swap (TRS) financing, structured repurchase agreements (repos), PB financing, special purpose vehicle (SPV) financing and subscription credit facilities. The program, entitled “An Introduction to Fund Finance Structures,” was moderated by Kara Bingham, Associate Editor of The Hedge Fund Law Report, and featured Fabien Carruzzo, partner at Kramer Levin; Matthew K. Kerfoot, partner at Dechert; and Jeff Johnston, managing director at Wells Fargo Securities, LLC.

This article, the second in a two-part series, provides an in-depth discussion of structured repos, SPV financing and subscription credit facilities. The [first article](#) explored basic principles of financing arrangements and provided an overview of PB financing and TRS financing.

For more on structured repos and SPV financing, see [“Three Asset-Based Financing Options for Private Funds: Total Return Swaps, Structured Repos and SPV Financing \(Part Two of Two\)”](#) (Apr. 12, 2018).

See also our three-part series on understanding subscription credit facilities: [“Popularity and Usage Soar Despite Concerns”](#) (Mar. 1, 2018); [“Principal Advantages and Key Points to Negotiate”](#) (Mar. 8, 2018); and [“Key Concerns Raised by Investors and the SEC”](#) (Mar. 15, 2018).

Structured Repo Financing

Key Elements of Structured Repo Financing

Traditional repos have been used for years for liquid assets like treasury and agency securities, Kerfoot said. Structured repos can be used for less-liquid assets, including commercial real estate and private debt. In a structured repo, a fund sells assets to a lender, and at an agreed-upon future date, the fund repurchases the assets from the lender.

A structured repo looks very much like a traditional secured credit facility. After the 2008 global financial crisis, there was some litigation over whether these arrangements are true repos or credit facilities. Market participants are now careful to ensure that they are treated as repos.

In a structured repo, the interest rate paid by the fund, or financing fee, is referred to as the “price differential,” Kerfoot explained. Any distributions from the purchased securities (dividends or interest) are paid from the lender to the fund as “income.” Repo agreements typically permit the lender to make margin calls if the assets depreciate in value. In turn, the fund often has the ability to call back excess collateral. Some structured repos are created from scratch, while others are documented on form master repurchase agreements.

TRS and repos are similar in structure, Carruzzo pointed out, and a TRS financing can often be documented as a repo and end up with a similar result. From a bankruptcy safe harbor perspective, however, the swap safe harbor is broader than the safe harbor for repos, which relies upon the securities contract safe harbor. Specifically, the safe harbor relied upon for TRS applies to any asset while, as its name implies, the securities contract safe harbor generally only applies to assets that are securities, and therefore is more limiting than the swap safe harbor. Additionally, in order to be eligible for the securities contract safe harbor, a fund must be an eligible market participant, meaning that it must have a sufficient volume of trading.

For more on bankruptcy risks, see [“Second Circuit Rules on Whether Repo Clients of Broker-Dealers Are ‘Customers’ Under SIPA”](#) (Jul. 30, 2015).

Key Negotiation Points in Structured Repo Documentation

Apart from differences in the relevant bankruptcy safe harbor, repos and TRS present basically the same issues, Carruzzo continued. In a committed facility, parties negotiate:

- the term of the repo;
- the ability to add or remove assets;

- portfolio criteria;
- credit line fees or credits for an unused line; and
- other common terms.

Repos present fewer voting issues than TRS. In the repo context, lenders can grant voting rights to the fund with lower recharacterization risk. Under applicable case law, as long as the parties call a transaction a repo, it will be deemed a repo for purposes of the bankruptcy safe harbor. There is less focus on cash settlement in a repo because the lender, as the buyer of assets, must return those assets to the fund at the termination of the transaction.

Lender Concerns

Underwriting analysis for structured repos is similar to underwriting for other types of asset-based financing, Johnston said. The fundamental credit and cash flow analyses for repos and TRS are similar. A structured repo, however, may make it easier for the lender to receive loan treatment for accounting purposes. It can also eliminate the mark-to-market volatility of a TRS. Also, depending on the asset, the lender may be able to treat the transaction as “wholesale,” rather than as a securitization, for purposes of regulatory capital calculations, thereby allowing the lender to offer better terms to the fund.

Advantages of Structured Repo Financing

Structured repos are very similar to TRS, although very different from PB financing, Kerfoot added. Unlike PB financing, structured repos are often used for very illiquid assets like real estate and private debt, and longer maturities – up to five years – are available.

Credit risk to the fund is more limited under a structured repo than under a TRS. Under a TRS, a leveraged asset could increase significantly in value during the life of the transaction, thereby exposing the fund to the lender’s credit risk. In the case of a structured repo, however, periodic payments are made from the lender to the fund. If the lender defaults, the fund could foreclose and retain the cash. Structured repos are not subject to mandatory margin and are never treated as swaps for CFTC purposes.

SPV Financing

Key Elements of SPV Financing

In SPV financing, the fund owns the assets it desires to finance, Carruzzo stated. In order to facilitate the SPV financing

arrangement, the fund manager typically establishes an SPV and the fund contributes those assets to the SPV. The SPV then enters into a conventional loan agreement with a lender, pursuant to which the loan is secured by the SPV’s assets and a pledge of the fund’s equity in the SPV. The loan-to-value ratio is similar to a repo haircut or initial TRS margin. The SPV distributes the loan proceeds to the fund.

To avoid consolidation with the fund, which increases the lender’s bankruptcy risk, the SPV is created as a limited purpose entity with “separateness” provisions in its governing documents that make it bankruptcy remote, including independent directors who control certain actions such as a bankruptcy filing, Carruzzo continued. This enables the lender to seize the SPV and sell assets in the event of a default.

Income generated by the assets, less interest on the loan, is typically distributed to the fund during the term of the facility. When assets like bonds are repaid, the SPV may be required to use the proceeds to pay down the loan or, alternatively, the proceeds may be distributed to the fund or retained by the SPV. There is a mark-to-market feature under which the SPV has to pay margin to the lender in the event of a decline in the value of the SPV’s assets.

Documenting SPV Financing

Documentation of an SPV facility is much more complicated than for a structured repo or a TRS, making an SPV more costly and time-consuming, Carruzzo added. Documents include:

- SPV formation agreements;
- loan agreement;
- security agreement for the pledge of the SPV assets;
- pledge agreement covering the pledge of the SPV equity to the lender;
- collateral control agreement for the financed assets and the cash generated from those assets;
- credit support agreement (if not embedded in the loan agreement); and
- legal opinions addressing bankruptcy remoteness of the SPV, true sale of assets from the fund to the SPV, bankruptcy non-consolidation and corporate and security interest opinions.

The fund must also provide a bad act guarantee to protect the lender from any acts the fund could take to prevent the lender from foreclosing on the SPV’s assets.

Advantages of SPV Financing

Unlike repos and TRS, SPV financing is well-suited for very illiquid assets, Carruzzo said. It also offers flexibility to a fund, Kerfoot observed. Because the lender only has recourse to the assets placed in the SPV, the fund is free to finance other assets at the fund level or through a different SPV with a different lender. The fund's other business activities are not subject to the covenants in the SPV loan agreement. The SPV, however, will have to report to the lender periodically to give the lender ongoing transparency into the SPV's portfolio.

Subscription Credit Facilities

Key Elements of Subscription Credit Facilities

Unlike asset-based financing facilities – including PB financing, TRS financing, structured repos and SPV financing – subscription credit facilities are secured by the fund manager's right to call capital from a fund's limited partners. In light of the capital commitment structures of private equity funds, these funds have frequently taken advantage of this form of financing. There has been a dramatic increase in the use of subscription credit facilities in recent years, however, driven by the significant amount of capital raised in the private credit and private equity sectors, with many credit funds, especially middle market and direct lending funds, being set-up as draw-down capital vehicles, Kerfoot said.

Traditionally, subscription credit facilities were used to enable a fund manager to purchase an asset quickly and later call capital from partners to repay the loan, Kerfoot explained. This is still the main way that private equity firms use these facilities. Other uses, especially early in the life of a fund, are for working capital, as well as payment of management fees and other expenses.

See "[Can a Capital on Call Funding Structure Fit the Hedge Fund Business Model?](#)" (Nov. 5, 2009).

Lender Concerns

When extending a subscription credit facility, the lender conducts a legal due diligence "deep dive" into the fund's

structure and governing documents, Johnston said. It wants to make sure that the manager has the right to call capital from the fund's limited partners, that the limited partners have the cash to pay their obligations to the fund and that the lender has access to that cash. The lender is less concerned about fund strategy or other assets.

A subscription credit facility provides the manager with considerable flexibility at the fund's outset, but that flexibility diminishes as the manager calls capital during the investment period, Johnston added. As limited partners pay in their agreed capital contributions, the manager must shift to other forms of financing.

Other Concerns Regarding Subscription Credit Facilities

Recently, some members of the financial press have cast a negative light on subscription credit facilities, which have the effect of boosting a fund's internal rate of return (IRR), Bingham observed. As the use of subscription facilities has grown, lenders have encouraged communication between managers and limited partners on the issue, Johnston said. While managers may sometimes use them to bump IRR, in other instances, investors may wish to use them to finance their own strategies or separate accounts. Market participants are trying to decide on the rules of the road, including the appropriate time to keep a draw outstanding, as well as whether different practices and terms should apply to different types of funds.

See also our three-part series on subscription and other financing facilities: "[Provide Funds With Needed Liquidity but Require Advance Planning](#)" (Jun. 2, 2016); "[Offer Hedge Funds and Managers Greater Flexibility](#)" (Jun. 9, 2016); and "[Operational Challenges](#)" (Jun. 16, 2016). See also "[How Can Private Fund Managers Use Subscription Credit Facilities to Enhance Fund Liquidity?](#)" (Apr. 4, 2013).