Fund Finance

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USA

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Overview of the subscription credit facility and fund finance market

The subscription credit facility (each, a "Facility") and related fund finance market in the United States (the "US") is at perhaps its most robust position ever. Despite a myriad of challenges coming on the heels of the financial crisis, the US Facility market (the "US Market") has grown by a significant margin (and in many cases, by double digits year-over-year). At Cadwalader, Wickersham & Taft LLP ("Cadwalader"), 2016 will undoubtedly be a record-setting year, both in terms of deal volume and growth of our global practice. While there is no tracking service to accurately measure the size of the US Market, we conservatively estimate, via an analysis of our own deal portfolio and anecdotal evidence from Lenders and other US Market participants, that the US Market is approaching $200bn in size based on Lender commitments.[1] This comprises by far the largest Facility market globally. The outpaced growth of the last half decade has been fuelled by many factors, including robust fundraising and an ever-evolving fund formation environment, sustained positive fund performance, and deep penetration of Facility offerings into the US private equity fund market. Facility usage is now the norm in the US Market, and yet there is still plenty of room for continued growth. This chapter summarizes the current state of the US Market, highlights key trends and challenges impacting the market, and forecasts notable developments for the coming year.

State of the market

Credit performance

Throughout 2016, US Facility credit performance has remained pristine with zero known loan losses or write-downs. To our knowledge, no institutional limited partner (each limited partner, an "Investor") funding defaults have occurred in the US Market thus far in 2016. None of the major lending participants (each, a "Lender") from the 50+ financial institutions in attendance at either of the 6th Annual Global Fund Finance Symposium hosted by the Fund Finance Association on March 2, 2016 in New York (the "2016 Global Conference") or the 2nd Annual European Fund Finance Symposium hosted by the Fund Finance Association on October 20, 2016 in London (the "2016 European Conference") reported a loss or payment event of default in the last 12 months. Similar to prior years, we have not consulted on any Investor capital call ("Capital Call") funding delinquencies, with the exception of a few by high net worth and family office Investors ("HNW Investors") that were subsequently remedied. While this positive credit performance is no surprise given recent history and data points in the US Market, it is worth noting that this perfect credit performance has once again extended to our hybrid and asset-level facilities, which are underwritten at significantly higher risk profiles.

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However, many Lenders have grappled with a significant rise in technical defaults caused by covenant breaches, predominantly related to borrower reporting obligations. We think this trend is simply a function of portfolio growth and the increase of newer private equity and investment funds (each, a "Fund") borrowing under their first Facility. Several active Lenders in the market are adding post-closing compliance checklists or training sessions with Funds in hopes of reducing these occurrences. Additionally, US Lender staffing constraints have been stressed by the outpaced growth of Facility portfolios (which, for some US Lenders, has been in the 10–30% range over the past 12–18 months). These portfolios have quite often churned out a steady (and increasing stream) of Facility amendments, joinders and collateral maintenance work. As a result, a number of mature Lenders have recently sought new hires, expanded portfolio management teams, completed internal reorganizations, instituted additional training sessions or a combination thereof to keep pace with the growth of the business.

New entrants and recent market development

New entrants (Lenders, law firms, etc.) have for some time tried to establish themselves in the US Market, each with different tactics. Beginning around 2012, certain new entrant movements occurred or accelerated that had the potential to be disruptive to the historical competitive dynamics, at least at the fringes. For example, multiple non-US Lenders were investing in and building their capabilities in the US. Similarly, and in reverse, many of the dominant US Lenders became increasingly attentive to Europe and Asia, recognizing the potential opportunities in those submarkets. Unlike some of their new-entrant predecessors, the non-US Lenders had real, demonstrable execution capabilities, even if primarily in a different submarket. As Lenders migrated in both directions, they brought their historical Facility structures and underwriting guidelines to the new submarket. As a result, Funds found themselves with an increased diversity in Facility offerings. Today, Funds are more often weighing significant structural variation (a traditional US Facility borrowing base (each, a "Borrowing Base") *vs.* a coverage ratio, as a simple example) in their Facility proposals.

Along a somewhat parallel path, multiple US regional Lenders have expanded beyond their historical coverage geographies and middle-market roots. This movement has been in an effort to better serve and grow with certain Fund clients. It is also a response to the near-perfect historical credit performance of US Facilities. As a result, many US regional Lenders have recently increased their Facility maximum-hold positions to levels comparable to that offered by some of the financial center Lenders, at least for certain preferred Fund sponsors. With increased relevance in the greater US Market, these regional Lenders have altered the competitive landscape. The Facility structures and underwriting parameters at these institutions often differ from those of a traditional Facility Lender. Such variances in structure may dictate the syndication strategy and prospects for a particular Facility, sometimes adding additional complexity to a transaction. For example, we have previously written about the interesting trend of "shadow borrowing bases" – where traditional US Facility Lenders, in order to participate in deals led by regional Lenders that employ coverage ratio style borrowing bases, underwrite the Investor pool according to the more traditional included Investor/designated Investor/concentration limit formula, but do it on a shadow basis, not conscripted in the credit documentation.

Given the competitive landscape in the US Market, Lenders are increasingly willing to move further down the risk continuum. Five or six years ago, we saw a strong movement away from historical requirements to deliver investor letters and legal opinions in the US,

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and we now continue to see a greater acceptance of less than ideal Fund limited partnership agreements ("LPAs").[2] Similarly, Lenders have developed concepts to lend against the uncalled capital commitments of Investors that have historically been excluded from Borrowing Bases. This includes lending against the commitments of sovereign wealth funds ("SWFs"), Texas state investors and other historically challenging Investors via the "hurdle" or "skin in the game" type concepts we have previously noted. Another recent trend has been the expansion, both in terms of frequency and size, of "HNW Facilities" – traditional subscription-style facilities made available to Funds comprised solely or almost entirely of HNW Investor commitments. These structural evolutions have also extended Borrowing Base availability later into a Fund's life cycle, further extending the market. Most notably over the past few years, we have seen a relatively significant expansion in the underwriting consideration of Fund assets, both in terms of supporting more aggressive Borrowing Bases and as a means of mitigating other perceived credit weaknesses in a particular Facility, such as a tight overcall limitation or similar Investor cease funding risk.

Taking this a step further, certain Lenders in the US Market are now actively considering net asset value-based facilities (each, a "NAV Facility") or hybrid variations. We anticipate this will continue as Lenders seek higher-yielding opportunities and aging Funds look for continued liquidity and/or leverage later in their lifespans, as Investor commitment-backed Borrowing Bases reduce. In fact, given some of the challenges present in the post-crisis investment/exit environment,[3] many Funds have expanded their tenors. The average lifespan of a private equity Fund is currently 13.2 years and increasing, up from 11.5 years in 2008[4] − a trend that will likely increase demand for later-term Fund financings. While each of these facilities is unique, we are seeing more consistent structures and increased frequency of the offerings. As more Lenders gain comfort with underwriting the particular Fund's assets, we expect this market to grow steadily, albeit continuing at a fraction of the size of the Facility market.

Fund performance

Fund performance throughout 2016 has continued to be a key factor driving overall US Facility growth. It should be no surprise that satisfied Investors seek to invest additional capital into new Funds. The most telling trend is that Investors continue to reap the benefit of hefty distributions at record rates. 2016 will mark the sixth consecutive year that Investors received more from Fund distributions than they funded via Capital Calls.[5] The net cash flows to Investors over the last five years alone have exceeded $300bn − equal to more than one-and-a-half years' worth of fund-raising during that same period.[6] In fact, according to data from Preqin, 98% of all Investors today have a generally positive view of Fund investment.[7] At each of the 2016 Global Conference and the 2016 European Conference, a Preqin presenter noted the excellent health of the Fund industry, as evidenced by respectable-to-exceptional returns, positive Investor sentiment and continued Fund growth, as fundraising has been in part driven by these increased net cash flows.

Fund formation and finance

Fund formation

We are seeing slightly decreased fund formation activity globally, including in the US. However, based on past experience and a strong US Fund market supported by record distributions, we are optimistic that fundraising activity will remain steady (and perhaps increase) into 2017. According to Preqin data, the first three quarters of 2016 saw 864 Funds raise a combined $425bn in Investor commitments.[8] This is the first time since

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2013 that fewer than 1,000 Funds have closed in the first three quarters of the year, and represents a 9% decline in aggregate capital raised compared to the first three quarters of 2015.[9] In fact, the third quarter of 2016 had 69 fewer Fund closings, with nearly $1bn less capital raised, than in the second quarter of 2016.[10] Most experts attribute some of this interim decline to uncertainty created by macro events, such as Brexit and the 2016 US presidential election. However, there is room for optimism, albeit in a crowded market. At the end of the third quarter in 2016, 2,935 Funds were seeking a total of $983bn in Investor capital compared with 2,798 Funds seeking a combined $938bn in the prior quarter.[11] Additionally, Preqin surveys show that 87% of Investor respondents expect to commit more or the same amount of capital to Funds in the next 12 months, with 43% expecting to increase commitments over the same time period.[12] Thus, our expectation is that even a moderate to healthy increase in consummated Funds and Investor commitments will lead to continued expansion of the US Market in 2017, perhaps with the most notable growth occurring outside of the traditional US Market with hybrids, NAV Facilities, and bespoke separately managed accounts ("SMAs") and other Investor-driven structures.

Fundraising delays are an additional challenge we are seeing impact the US Market. Depending on asset class, Preqin reports that the time to first close for many Funds has now reached or exceeded 20 months. As Facilities are often discussed in the early stages of Fundraising and many times even structured and documented to coincide with a Fund's initial Investor closing, this is creating some noticeable delays in Facility closings. The deals are eventually closing, but these timing delays present some challenges as Lender credit approvals expire and/or final Borrowing Base composition (and other terms) change based on final Investor makeup at Facility closing compared to the indicative list initially provided by the Fund. We anticipate these delays may continue into 2017 given the competitive and crowded fundraising market and the increased Investor sophistication and appetite for bespoke structures and terms.

<u>Investor influence on structuring</u>

Today's Investor influence is a frequent driver of US Facility structures. Over the past few years, Investor recognition and consideration of Facilities has increased dramatically, and many Investors now pay close attention to how Facilities are structured and the related delivery and reporting obligations. Investors even negotiate Facility-related provisions into their side letters with the Fund. These often express a desire to limit their obligations to deliver financial statements or other information to Lenders. Some tax-exempt Investors may also insist on several liability, borrowing clean-down periods and/or certain limits on cross-collateralization with respect to the individual parallel funds or SMAs they invest through, in order to preserve a more favorable tax structuring analysis, such as limiting unrelated business-taxable income. Whether facilitated via efforts of the Institutional Limited Partners Association or simply via greater investing experience, Investors are more sophisticated and more aware of the Facilities their Funds are entering than ever before.

One key example of the direct impact Investor influence is having on US Facilities is the growing use of SMAs. Investor preference for an SMA investing structure is driven primarily by the desire for more control and lower management fees with the Fund. Typically only Investors with the highest commitment levels (such as US state pensions or SWFs) currently employ SMAs in their investing strategy. In 2013, we predicted steady growth in the volume and frequency of commitments to Funds by SWFs, and in the use of SMAs generally by Investors. At that time, Preqin estimates showed that SWFs had just

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surpassed the $5trn mark for total assets under management. That number has grown to $6.51trn through March of 2016, increasing by nearly $1.5trn in less than a three-year period alone.[13] Also, according to 2013 data, only 19% of Investors surveyed by Preqin indicated that they used and/or were planning to use SMAs. Today, that number has increased to 32% of Investors.[14] Additionally, 30% of Investors expect to increase their level of SMA activity in the long term.[15] Thus, including SWFs in Borrowing Bases and single Investor exposure when setting up Facilities for SMAs has become a permanent fixture in the US Market. Three years ago, we closed only approximately three SMA Facilities in the entire year. Through the first three quarters of 2016, Cadwalader has closed 12 SMA Facilities, with another three in progress.

Security structures

- *Traditional subscription facilities*

A traditional US Facility is defined by its collateral package, which will typically include a pledge by the Fund and its general partner (each, a "GP") of all rights, titles and interests in and to: (i) the unfunded capital commitments of the Investors; (ii) the right to make Capital Calls upon the Investors; (iii) the right to collect the proceeds of, and enforce the making of, such Capital Calls; and (iv) the deposit account (the "Collateral Account") into which Investors will fund their capital contributions when called (collectively, the "Facility Collateral").

The Facility Collateral is characterized as a "general intangible" or "payment intangible" under Article 9 of the Uniform Commercial Code (the "UCC"). A security agreement and/or series of pledges and security agreements are used to create the Lender's security interest in the Facility Collateral. With respect to each pledging Fund and its GP, a UCC filing pursuant to Article 9 of the UCC is the method by which Lenders perfect such security interest. The applicable filing office is dependent upon the jurisdiction of formation of such pledging Fund or its GP, as applicable. The Collateral Account is perfected via an account control agreement entered into by and among the pledging Fund, the depository bank holding such account and the Lender. These accounts are typically "springing" whereby the Lender will obtain exclusive control by way of presenting the depository bank with notice upon the occurrence of a certain event under the Facility (typically, Borrowing Base deficiencies, pending defaults and ripened events of default). In addition to pledging the Facility Collateral, the GP also grants the Lender a power of attorney to issue Capital Calls in the GP's name during a default.

For most US Facilities, New York law will govern the loan and related security documentation. If one or more Funds are formed or secured accounts are held in non-US jurisdictions, then local counsel should be consulted regarding any local law requirements for perfecting security and recognition of a US judgment.

Facilities are full recourse to the Fund, and typically underwritten with borrowers on a joint and several basis. This is to provide full cross-collateralization across any parallel funds and alternative investment vehicles in the structure, which is a necessity in deals with a single Borrowing Base comprised of Investors that commit to multiple Funds within the structure. Sometimes, due to US law concerns under ERISA or the tax code, Facilities will be structured via "cascade" pledges that utilize a series of security grants to indirectly pledge certain Fund interests to the Lender. Where several liability is an option, cross-secured or cross-collateralized structures may be used to effectively link the ability to call from all Investors in each Fund during an enforcement scenario. Additionally, Facilities may be structured via separate "Onshore" and "Offshore" facilities or "umbrella" style

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silos (the former being utilized where no cross-security or linkage across parallel funds is permitted, and the latter for efficiency's sake where it makes sense to document multiple Facilities, each for a separate vintage or fund series with respect to a single sponsor, in one set of transaction documents). Whether or not a particular approach will work for a Lender will ultimately depend upon its underwriting criteria as applied to the given Fund, including, but not limited to, the composition of the Fund's Investors and whether one or multiple Borrowing Bases is feasible to achieve the desired Facility size and usage.

- *NAV and hybrid facilities*

While some Lenders may consider NAV Facilities on an unsecured basis (where the assets are high-quality and fairly liquid in an enforcement scenario), most US Lenders will require security over some assets of the Fund. NAV Facilities are not typically secured by all underlying investments of the Fund. Such an "all asset" arrangement is quite often commercially challenging given potential transfer restrictions, third-party consent rights, change of control triggers and/or other perfection or foreclosure issues. The collateral varies widely from deal to deal and generally includes some combination of: (a) cash distributions and liquidation proceeds from Fund investments; (b) equity interests of special purpose vehicles or holding companies via which the Fund owns the "eligible investments"; and/or (iii) less frequently, direct equity interests in such investments. The idea being that, in a default scenario, the Lender will have the right to foreclose on the collateral, and either take direct ownership control of the equity interests or sell such interests and apply the sale proceeds to satisfy any remaining Facility debt.

The method of perfecting the security interest in cash distributions and liquidation proceeds is akin to a traditional US Facility. Such distributions and proceeds are directed and/or swept into an account that is pledged to the Lender and subject to related withdrawal restrictions. The account or accounts will be subject to account control agreements in favor of the Lender. The pledged equity will either be perfected via Lender control of certificated securities or over a securities account, in each case, pursuant to Article 8 of the UCC or by way of UCC filings where such interests are characterized as "general intangibles" under Article 9 of the UCC (which is generally the case where the interests are issued by holding companies formed as limited liability companies or partnerships unless such company elects to "opt into" Article 8 of the UCC). In less common situations where the collateral package includes a direct lien on the Fund's investments, control over a securities account or custodial arrangements may be used by the Lender. If non-US entities or non-US accounts are present in the collateral, then additional non-US security documentation and means of local law perfection may be required.

Hybrid facilities are generally considered to be some combination of a traditional US Facility and a NAV Facility, whereby the Lender acquires a security interest over certain assets of the Fund as well as remaining uncalled capital of (and related Capital Call and enforcement rights with respect to) the Fund's Investors. The means of perfecting each component of the collateral will require a legal analysis under the UCC, but will generally be subject to the aforementioned methods.

Key legal developments

<u>New margin regulations</u>

A popular feature of US Facilities over the past few years has been the inclusion of a secured hedging facility. Under such arrangement, the Fund may enter into swaps with the Lender that are secured by Facility Collateral pursuant to the Facility documents (subject to agreed

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trade allocation thresholds, which amounts, when utilized for trades, are subtracted from Borrowing Base availability). From March 1, 2017, all uncleared "swaps" entered into by swap dealers are subject to margin requirements that will generally require counterparties to post cash or similar highly rated "eligible collateral".[16] Lenders that are swap dealers will be subject to the new rules.[17] However, these requirements are generally not applicable to "foreign exchange forwards" and "foreign exchange swaps", as those terms are defined under the US Commodity Exchange Act (collectively, "Excluded Swaps").[18] Going forward, it will be prudent for Lenders to include language that "the Borrower understands and agrees that applicable law may require the Lender to impose independent collateral requirements on lender hedging agreements." While this is likely to have some impact on the utility of such secured hedging facilities (and maybe no impact, to the extent hedging activity is limited to Excluded Swaps), access to a Facility will certainly be beneficial to Funds that need to post cash or letters of credit to satisfy the requirements for non-Excluded Swaps.

Heightened sanctions / AML focus

On September 1, 2016, the Loan Syndications & Trading Association ("LSTA") published new guidance on the inclusion of sanctions and anti-money laundering provisions in US loan transactions.[19] While the market has slowly started to settle on standards similar to the LSTA recommendations, a number of Lenders have policy guidelines that differ slightly. Also, some gaps do exist for fund finance transactions given that the LSTA provisions were drafted generally with non-Fund borrowers in mind. As a result, knowledge qualifiers on certain reps and warranties, the scope of sanctions authorities (including non-US authorities in US Facilities), and reps and warranties regarding Investors as sanctioned persons are frequently negotiated in US Facilities. The issues are extremely sensitive to Lenders since they could face potential civil or criminal liability, commercial risk relating to possible non-repayment by Funds facing sanctions liability, and also franchise and reputational risk associated with engaging in business with Funds or Investors who are associated with sanctions targets. While many of these issues should be addressed on a case-by-case basis, they do present interesting syndication challenges especially where non-US Lenders or Funds are party to a US Facility led by a US Lender. As a result, we are frequently seeing a prudent expansion of the scope of sanctions-related provisions in US Facilities, and expect this trend to continue into 2017.

Case law update

There have been no material updates during the prior year in US case law relevant to enforcing Investor capital commitments.[20] In fact, the often cited *In re LJM2 Co-Investment, L.P.* and *Iridium* cases remain good law in Delaware, and continue to stand for the proposition that capital commitment funding obligations by Investors are enforceable for debt repayment in spite of a Fund bankruptcy or bad faith modification of Investor funding obligations.[21]

Bail-in

As part of the continuing measures by national authorities in the European Union ("EU") and the EU itself to avoid a repeat of the taxpayer bail-outs of financial institutions required after the 2008 financial crisis and as part of an EU-wide directive (the Banking Regulation Recoveries Directive (the "Directive")) introduced as part of the measures to deal with this issue, compulsory "Bail-in" provisions were introduced across the EU covering European Credit Institutions and Investment Firms in January 2016. The intended effect of a "Bail-in" is to allow the write-down or conversion of unsecured debt of a relevant institution, where that institution is failing or likely to fail. In effect, it enables such write-downs or

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conversions to be imposed prior to an actual insolvency of that institution so that (along with other measures) systemically important parts of that institution or its business can be continued.

These provisions (referred to in the Directive as the "Bail-in tool") apply automatically to any obligations of an EU/European Economic Area ("EEA") incorporated relevant institution in any contract governed by the laws of an EU or EEA country involving such institutions. For contracts governed by laws other than those of an EU or EEA country involving such institutions (e.g. the US), Article 55 of the Directive ("Article 55") requires that specific "Bail-in" language is included in the relevant contract. A number of industry bodies, including the Loan Market Association in the United Kingdom, the International Swaps and Derivatives Association, Inc. and the LSTA in the US, have drafted relevant language for inclusion in contracts. The relevant institutions are subject to penalties (fines and/or restrictions on and/or removal of licensing) if the language is not included where it should be. For subscription finance transactions, the primary areas of documentation where such language may be required to be included are the credit and security documents, but inclusion may also be required (and should be considered) in Fund documentation (e.g. subscription agreements and potentially, LPAs and/or side letters) where relevant institutions (or their subsidiaries or associates) are or may be parties to those arrangements.

Following industry pressure, some exceptions to the compulsory "writing in" of the Bail-in terms under Article 55 have been allowed (in the UK effected by the Prudential Regulation Authority as of August 1, 2016). These exceptions generally relate to situations in which the inclusion of the specific language would be prohibited or contradictory to law or regulation, and not simply commercially "inconvenient". So in general, and unless one of the limited exceptions can be applied, Bail-in language should be included in all new contracts and/or material amendments to existing contracts made or effective after January 1, 2016. Notably throughout 2016, we have already experienced a large push by EU Lenders in US syndicated Facilities to include the new prescribed Bail-in language and we expect this will be a permanent fixture moving forward.

Brexit

To the surprise of almost everybody, in June 2016, the UK voted in a referendum to exit the EU. Since the vote, there has been a great deal of political and legal confusion and argument about exactly what the vote means and how that vote will be or can be implemented.

The latest indications are that the UK Government will, subject (as per a recent decision of the High Court in the UK and currently being appealed to the UK Supreme Court) to UK Parliamentary approval, trigger a two-year period of negotiation on the terms of the UK exiting the EU under Article 50 of the EU Constitution, some time around February/March 2017, which (if the two-year timetable was adhered to) would mean an actual exit on terms in 2019, although there are some relatively persuasive views that the process may take a great deal longer than that. There is, as of yet, not a great deal of clarity on the likely terms of that exit. The latest indications are that it will be a relatively "hard" exit (but with a likelihood of building in some protection for various significant industries, for example the automobile and financial services industry), but this is subject to significant change depending on the political and commercial climate.

For Funds and the fund finance market (as with any other industry) it is really "too early to tell" in terms of the precise impact of Brexit. For Lenders and Funds, by far the most significant "macro" impact of the Brexit vote and negotiations will be the preservation (or not) of "passporting" rights between the UK and the rest of the EU (by which currently

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institutions situated in one EU country can effectively carry on business and/or market to commercial investors in any other EU country). Should that or equivalent no longer be available (or even be called into question), then both Lenders and Funds are likely to move at least some of their deal making and other resources and focus "out" of the UK and into a continuing "EU" country or countries. In terms of the "micro" impact (e.g. on credit documentation), the impact currently is minimal, since until the conclusion of the Article 50 process the UK remains part of the EU and contractual provisions currently are based on that premise. That may change as the exit negotiations continue and matters become clearer, at which point (a) there could be some impact (particularly if there was a "hard" Brexit) on the more "technical" side of contractual terms relating, for example, to jurisdiction and enforcement and/or matters relating to sanctions, increased costs or "Bail-in", and (b) some more substantive impact on commercial terms (covenants, etc.) to the extent that the Brexit terms started to have a real impact on the commercial and credit aspects of credit or Fund documentation. At a minimum, the uncertainty has been interesting to the US Market at large and is likely to be somewhat impactful, given that Brexit has real implications on fundraising, formation and investment strategy for Funds with UK touch points and commercial implications for UK Lenders, that in each case, participate in US-based Facilities.

The year ahead

To date, 2016 has included a number of challenges to the US Market: continued global macro-economic and political uncertainty (including Brexit and the US presidential election), reported declines in fundraising, increased delays with initial Investor closings and increased Investor preference for SMAs, which are more challenging to lend to than traditional commingled fund vehicles. Yet, US Facility deal volume remains robust and will likely finish above 2015's pace. While we expect 2016 deal volume to ultimately finish at or ahead of the 10% growth that we forecasted at the end of 2015, a strong finish to the year will be necessary. However, the pipeline of both large syndicated transactions and bilateral deals forecasts well for the remainder of the year and into the first quarter of 2017.

This growth is being driven by the same factors that have been driving the US market for some time. There are still Funds being introduced to the Facility product, and market penetration has been and remains a primary growth driver, especially in the middle market buyout space. Further, many Lenders continue to adjust their maximum hold positions, leading to larger availability for the larger Funds currently being formed. Finally, asset-based lending to fund-of-funds and secondary Funds secured only or primarily by their underlying fund interest investments has increased considerably (at possibly the highest rate in recent years), and we think this growth will continue into 2017. We also expect the recent fundraising declines of the third quarter 2016 to reverse course. All told, we forecast continued growth in the US Market to be in upper single digit range (6–9%).

There are simply too many factors to support a more pessimistic view. With a record number of Funds actively fundraising and record levels of cash distributions year-over-year since 2010, we are hard pressed to forecast a meaningful decline in 2017 Fund formation. Even assuming some macro-level economic and political volatility, we think the US Market has plenty of headroom for uncorrelated growth given Fund volume and unprecedented levels of dry powder relative to actual US Market size.[22] While US Facility structures have been trending moderately in favor of Fund borrowers for years, we continue to believe that the credit profile of market-structured US Facility transactions forecasts well for US Facility

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performance in the year ahead, and we do not forecast any systematic or wide-spread default or loss occurrences. Thus, the state of the US Market should remain strong in 2017.

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Endnotes

1. We estimate the global market is approximately $300bn in Lender commitments.
2. We should note that this trend has been somewhat more muted in 2016 compared to prior years. The increasing concentration of Funds with the top tier Fund formation law firms has been a significant positive for the US Market, as these firms are intimately familiar with lending requirements and tend to produce bankable Fund LPAs from the outset. This positive trend on the collateral side of US Facility structures has somewhat reduced the prevalence of asset-level mitigants, such as net asset value covenants, periodic clean-downs and covenants to call capital.
3. According to the *Preqin Investor & Fund Manager Surveys – June 2016*, 65% of Investors listed Pricing/Valuations as the biggest challenge for the next 12 months.
4. Source: Palico as reported by Law360, *PE's Rising Enchantment with Unconventional Fund Terms* by Benjamin Horney, October 24, 2016.
5. $475bn was returned to Investors in 2015 alone according to data presented by Preqin at the 2016 Global Conference.
6. See, *2016 Preqin Report*, p. 43.
7. See, *Preqin Investor Interviews*, *June 2013-June 2016* ("Preqin Investor Interviews"); the Preqin Investor Interviews also noted that 89% of Investors feel that their private equity Fund investments have lived up to expectations over the past 12 months; also 63% of Investors surveyed believe that Fund manager and Investor interests are currently aligned.
8. See, *Preqin Q3 2016 Fundraising Update* (the "Preqin Fundraising Update"), p. 1.
9. *Id.*
10. *Id.*
11. *Id.*
12. See, *Preqin Investor Outlook: Alternative Assets H2 2016*.
13. See, *The 2016 Preqin Sovereign Wealth Fund Review*.
14. *Preqin Investor Interviews, June 2016*.
15. *Id.*
16. See, Commodity Exchange Act ("CEA") Section 4s(e).
17. See, 80 Fed. Reg. 74839 (Nov. 30, 2015).
18. See, Sections 1a(24) and 1a(25) of the CEA.
19. See, "*LSTA Guidance Regarding US Sanctions Issues in Lending Transactions*".
20. We should note that there have been some recent disputes between Investors and GPs that have led to litigation in the US. See *Wibbert Investment Co. v. New Silk Route*

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PE Asia Fund LP et al., case number 650437/2013, in the Supreme Court of the State of New York, County of New York. Wibbert sought to avoid making a Capital Call seven times alleging fraud on the part of New Silk, but, according to the last publicly available reports, ultimately funded its capital commitment in order to preserve its status as a limited partner in the Fund.

21. See *In re LJM2 Co.-Investment, L.P.*, 866A. 2d 762 (Del. Super. Ct. 2004) and *Chase Manhattan Bank v. Iridium*, 307 F.Supp 2d 608, 612-13 (D. Del. 2004); local counsel should be consulted for non-Delaware jurisdictions, which often have similar case law: see *Advantage Capital v. Adair* [02 Jun 2010] (QBD) Claim no. HQ10X01837 (Order for breach of contract granted in favor of private equity fund that sued a limited partner for repudiation under English law).
22. With a reported $1.43trn in dry powder available globally (see *Preqin Fundraising Update*) and assuming a global Facility market size of $300bn in Lender commitments, this still only yields a global advance rate of approximately 21%. Most Lenders have an average blended advance rate of closer to 30% across their portfolios, which suggests there is still ample room for growth via penetration into new Funds (with the US Market capturing a large proportion).

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Wes has served as lead counsel on many of the largest and most sophisticated fund financings ever consummated, notably having assisted more than 35 banks as lead or syndicate lender during the past two years with transaction values totalling in excess of $25bn. Many of the transactions he advises on are precedent-setting, carrying unique structures and complex international components – whether that be foreign limited partners or funds, multi-currency advances or foreign asset investment.

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