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Top Considerations for Structuring an SMA

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Facilities for separately managed accounts ("SMAs") have been on the rise the last few years. Until now, COVID had slowed down the momentum for 2020 (last year, we closed 15 SMA facilities, but through the first half of 2020, we have closed only 5). This was partially due to banks tightening their credit standards. Single investor risk, and particularly risk from certain public pension funds in the 2020 environment, has not been an attractive sell internally. As we enter the fourth quarter, things have started to normalize a bit, and we are seeing a healthy amount of SMA facilities close or mandate with others still in term sheet phase. In fact, we are currently working on six SMA facilities and now expect to narrow the gap with our 2019 numbers and possibly even finish net-up by end of the year in total number of SMA facilities closed.

As a rapid refresher, SMAs are simply a fund of one – generally set up as an investment vehicle for a single investor that invests in a particular fund or with a particular manager. The arrangement provides the greatest amount of customization for the investor. The structure and investment strategy is frequently driven by tax, reporting requirements, special consent rights and lower fees with the manager. The lion's share of SMAs are established by very large sovereign or institutional investors and frequently with a top sponsor or one with an established track record in a particular asset class. The commitments are usually the largest in any particular fund strategy and will be documented via a partnership agreement and investment management agreement.

SMA facilities for the most part tend to mirror regular commingled subscription facilities. The key difference is a borrowing base and collateral package comprised of one investor's commitment. As a result, SMA facilities almost always price at a premium, reflecting the added risk of lending to a single investor structure.

Below are my top 10 considerations for structuring an SMA facility. This is by no means an exhaustive list. You can often get sideways, not understanding the bespoke nature of the fund or nuanced issues relevant for the particular investor. If you need help, please call.

1. Know your investor. Before you get too far down the path, identify the legal name of the investing entity. Is the investor the rated pension or an SPV set up to invest specifically in the subject fund? The sponsor will always call it by the household name, but it will be a bad surprise when you receive the subscription docs and find out that it's really XYZ LLC, a wholly-owned SPV of the rated pension. A comfort letter or guaranty may be needed to establish a sufficient credit link to the rated parent in this case to underwrite the facility on acceptable terms.

2. Know the fund documents. Diligence the LPA, subscription agreement and side letter (if applicable) with a view that any issue material to the lender needs to be addressed from the outset. Have documents amended or enter into an investor letter that the lender can rely upon and that will cure certain issues to the extent they intersect with the facility. Investor letters (and sometimes legal opinions) are a common if not universal requirement for SMA facilities. Nearly 90% of our investor letter deals last year were SMA facilities.

3. Include a ratings trigger. Include a specific ratings downgrade trigger for the single investor as an exclusion event. Lenders will want to exclude the investor from the borrowing base prior to it dropping below the typical investment grade requirement, which is acceptable in a commingled facility but not in a single investor exposure scenario. Typically, this ratings trigger is set at one or two notches below the LP's rating as of initial underwriting.

4. Supplement your EODs. Where the credit underwrite is a single investor, bankruptcy or failure to timely fund a capital call by such investor should trigger a facility event of default as opposed to simply an exclusion event.

5. Include early maturity triggers. Any exclusion event (other than bankruptcy and payment default – see 4 above) should trigger early maturity of the facility following a negotiated grace period – typically, 30-60 days. The exclusion event itself will trigger a full repayment of outstandings on the facility, given that the entire borrowing base is comprised of this one investor. However, the facility would not otherwise terminate without this trigger. The grace period gives the fund some ability to cure and reinstate the facility while not putting the lender in the position of holding an ongoing commitment with zero usage.

6. Protect the quality of your collateral. Transfers and withdrawal rights by the single investor should be prohibited without prior lender consent. It's common for governmental pensions to request transfer rights to an affiliate. However, these too should be subject to lender consent to ensure that the affiliate is of the same or greater credit quality and/or should be subject to delivery of a guaranty from the parent or other acceptable credit provider that is of equal or greater credit quality than the initial investor.

7. Review reporting needs. Reporting requirements may need to be tightened or enhanced, given that the administrative burden on the fund is low with a single investor but the risk to the lender and need for prompt information is high. Diligence and statutory issues concerning the specific investor may also call for special reporting – *i.e.*, placement agent disclosures, political contributions, no-hire policies, etc. This is also true where the fund documents require the GP to deliver certain notices or reports as a condition to the investor's continuing obligation. Additionally, if the investor does not have a public credit rating but was instead underwritten with an internal rating based on the lender's policies, then updated financials and other information used to establish such a rating will be required on an ongoing basis.

8. Understand immunity. If the investor is a sovereign entity or has other similar immunity, then either a waiver or other acceptable comfort regarding enforceability of its capital commitment and the lender's ability to enforce in the unlikely scenario of a default will be needed. Sometimes, this is simply understanding statutory or common law waivers already available for contractual claims.

9. Understand security requirements and best practices. Copies of notifications to investors regarding the facility for security or constituent document reasons, if applicable, should be provided to the lender. In most cases, these notices should also be acknowledged by the investor, given the administrative and commercial ease of obtaining from one investor (as opposed to hundreds in a commingled facility).

10. Use your umbrella with care. Umbrellas for SMAs do exist, and the SMA nature creates some additional complexity. Care may need to be taken regarding (i) confidentiality if different investors or lender groups are involved and (ii) differing terms, especially with respect to diligence issues that give rise to bespoke reps or covenants that will apply to one investor but not another. Also, cross-collateralization and cross-defaults are generally not included except with respect to a common GP/manager or investor, and as a result, each fund should have its own separate borrowing base. A more detailed discussion on umbrella facilities may be found **here**.