

CADWALDER

## Get To Know Your BDCs

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BDCs (defined below) were introduced to the subscription finance scene a few years back as they rode the growth wave of private debt funds following the financial crisis. Now, they seem ever-so-popular in our market – witness the doubling of the federal statutory leverage limitation applicable to BDCs last March, a sure driver of growth.

A business development company (“BDC”) may sound like a toddler mumbling the alphabet, but it has become a serious component of the private debt market today. Some have forecast that the size of the direct lending market will reach \$1 trillion by 2020. Of this, according to a March 2019 report on BDCs issued by Deloitte, BDCs have increased in total assets from \$23 billion in 2009 to \$101 billion through 2018. A remarkable growth rate by something with such a boring name. And now, many top sponsors are taking their horse to the old town road.

BDCs were originally designed to provide investment to “Mom and Pop” shops. Congress passed the Small Business Incentive Act of 1980, which amended the Investment Company Act of 1940 (the “40 Act”) to add BDCs as a new category of investment company. Akin to a closed-end investment fund, the recent explosion of growth in the BDC market has been on the private side. However, a BDC can be spun off into a publicly traded fund, much like a mutual or exchange traded fund – providing the “average Joe” with the ability to invest and gain exposure to broadly diversified securities in privately held small and middle market companies without incurring corporate-level tax.

Per the Small Business Credit Availability Act, passed by Congress in March of 2018, BDCs are now permitted to employ leverage at a 2:1 debt-to-equity ratio (previously 1:1 before passage of the legislation). This, and the sponsor-driven private closed-end capital call style mechanics of the recent wave of BDCs, is creating more opportunity for subscription line debt to bridge BDC fund investment into the middle market. Year-to-date, Cadwalader has already closed more sub lines for BDCs than in all of last year, and we have closed 9 total in the last 18 months.

A few things to keep in mind when you structure that next subscription line for a BDC:

- BDCs are typically structured as Delaware limited liability companies and not as partnerships. The nomenclature in the corporate documents will differ quite a bit from what many subscription lenders are accustomed to seeing.
- In many cases, the facility authorizing language and investor acknowledgments will be included in the subscription agreements or the offering memorandum (incorporated by reference in the subscription agreements) as opposed to in the operating agreement or bylaws.
- There will also be no general partner per se as the company will be run by an independent board. The finance documents should be updated accordingly to reflect the fund structure, parties and terminology.
- Shares are often issued by the company in exchange for capital contributions. Lenders should ensure that each shareholder has received adequate consideration in connection with its capital commitment, along with a waiver of share issuance (or authorization to issue) in the case of a lender calling capital in order to avoid a potential problem during an enforcement scenario. Language can often be added to the corporate documents or comfort gained through a more fulsome defense waiver from the investors in favor of the lenders.
- Lenders should understand the timing and ramifications of a public offering, merger or spin off of the fund and how it impacts the investor base and obligation to contribute capital. In most cases, early notification of these liquidity events and an early maturity or default trigger may be needed to ensure adequate time to call capital for repayment.
- The 40 Act representations and warranties, covenants and legal opinions will all differ from the traditional fund, as a BDC will be a registered investment company (“RIC”). Specific covenants regarding compliance with investment policies and negative covenants or default triggers for failing to maintain RIC status and/or comply with the 40 Act should be considered.
- The offering memorandum and other corporate documents may need to be picked up under the negative covenant for material amendments.
- The leverage limitations, in addition to citing any relevant provisions in the corporate documents, should also generally require compliance with the 40 Act requirements.

- Tax distributions will almost certainly be negotiated. RICs are domestic corporations that benefit from a special rule: they can deduct their dividends, and thus are subject to corporate-level tax, only on their undistributed net income and gain. A RIC generally must distribute 90% of its net ordinary income each year to maintain RIC status. Many RICs promise their investors that they will use commercially reasonable efforts to distribute 100% of their net income and gain each year, and will likely negotiate their credit lines accordingly. Understandably, there is friction as lenders do not like, and often cannot accept, investors being paid first during a borrowing base deficiency or event of default type scenario.
- BDC facilities may limit multi-jurisdictional complexity and cost, given somewhat simple fund structures and tax benefits that may alleviate the need for offshore vehicles.
- Subscribers can be in the hundreds, which may add costs via diligence. There are ways, however, to efficiently manage this process, particularly where the cost stresses the deal, while still protecting the bank.

# Lending to Venture Capital Funds

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By **Patrick Calves**  
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What is the Venture Capital Fund Adviser Exemption under the Investment Advisers Act and why is it relevant to loan facilities?

Historically, certain investment advisers to private funds had been exempt from registration with the SEC pursuant to the Investment Advisers Act of 1940 (the “Advisers Act”) under the so-called “private adviser” exemption (*i.e.*, investment advisers who (i) had fewer than 15 clients in the preceding 12 months; (ii) did not generally hold themselves out to the public as investment advisers; and (iii) did not act as advisers to registered investment companies or business development companies). However, the Dodd-Frank Act replaced the “private adviser” exemption with narrower exemptions for advisers that advise exclusively venture capital funds (the “VC Fund Adviser Exemption”); advisers solely to private funds with less than \$150 million in assets under management in the United States (the “Private Fund Adviser Exemption”); and certain foreign private advisers. (Note that advisers relying on the VC Fund Adviser Exemption or the Private Fund Adviser Exemption – generally referred to as “exempt reporting advisers” – are still subject to limited public reporting requirements, including certain parts of Form ADV, and certain limited compliance obligations.)

In its proposing release to define “venture capital fund” for purposes of the VC Fund Adviser Exemption, the SEC expressed the view that venture capital funds are “long-term investors in early-stage or small companies that are privately held, as distinguished from other types of private equity funds, which may invest in businesses at various stages of development including mature, publicly held companies.” Based upon this view, as well as the SEC’s understanding that such funds are “generally not leveraged,” the SEC narrowly defined “venture capital fund” in SEC Rule 203(l)-1 to include, *inter alia*, funds with a limitation on the amount and duration of any indebtedness that the fund may incur (see further discussion below).

## The Five Criteria for Venture Capital Funds

For purposes of the Venture Capital Fund Adviser Exemption, a “venture capital fund” is defined in SEC Rule 203(l)-1(a) to be any “private fund” (as defined in the Dodd-Frank Act, a “private fund” is any fund that would be an investment company but for the exclusions contained in Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act of 1940, the “Investment Company Act”) that satisfies each of the following five criteria:

- represents to investors and potential investors that it pursues a venture capital strategy (although the SEC has advised that the fund need not use the words “venture capital” in its name or otherwise: the SEC will make the determination of whether this criterion is met by analyzing the facts and circumstances of each particular case);
- immediately after the acquisition of any asset that is not a “qualifying investment” (*i.e.*, essentially equity investments in, and acquired directly from, a “qualified portfolio company,” which is generally a private operating company that does not incur debt to make distributions to the fund in consideration of the fund’s equity investment) or a “short-term holding” (*i.e.*, cash, U.S. Treasury securities with a remaining maturity of 60 days or less and shares of money market funds that are registered under the Investment Company Act), the fund holds no more than 20% of the fund’s aggregate capital contributions and uncalled committed capital in assets (other than “short-term holdings”) that are not “qualifying investments,” valued at cost or fair value (consistently applied).
- does not incur leverage – whether through loans, the issuance of debt obligations, the provision of guarantees or otherwise – in excess of 15 percent of the venture capital fund’s aggregate capital contributions and uncalled committed capital; and any such leverage is for a non-renewable term of no longer than 120 calendar days (except that any guarantee by the venture capital fund of a qualifying portfolio company’s obligations up to the amount of the venture capital fund’s investment is not subject to this 120-day limit);
- does not offer its investors redemption or similar liquidity rights (except in “extraordinary circumstances”). However, *pro rata* distributions to all holders are permissible; and
- is not an SEC-registered investment company or a business development company.

## Practical Considerations

A few things to keep in mind when structuring credit facilities with venture capital funds and investment advisers relying on the Venture Capital Fund Exemption:

- Specific covenants regarding compliance with investment policies and negative covenants or default triggers should be considered for failure of a fund or its adviser to stay within the parameters of the “venture capital fund” definitions and/or the Venture Capital Fund Adviser Exemption generally.
- Subscription-line facilities should include financial covenants and conditions to borrowing tied to compliance with the maximum leverage limit in the “venture capital fund” definition, as well as borrowing clean-down provisions that require any outstanding loans to be repaid within 120 days of borrowing and subsequent drawdowns to be tied to subsequent capital calls.
- Lenders should be mindful to do careful diligence with fund constituent documents to determine the consequences of the fund’s adviser violating the Advisers Act. In particular for subscription-line facilities, lenders should ensure that, following any removal of the fund’s adviser or a termination of the fund’s investment period as a result of the removal of the fund’s adviser or the adviser’s violation of the Advisers Act, investors are still obligated to make capital contributions to repay the fund’s indebtedness.

## Subscription Finance Loan Agreement Series — Part 2

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Borrowing Base/Leverage (or coverage)-based covenants: Considerations and issues with each.

In last week's kick-off to this series, we considered the parties to the Loan Agreement. In Part 2, we look at a (if not *the*) core part of the Subscription/Capital Call Facility certainly from a credit perspective, which is the extent to which investor commitments can be and should be counted in calculating the amount of facilities that can be made available to a borrower in a fund context. In doing so, we are going to take a look at two distinct approaches to this – one is a more traditional “European” approach (which is to look at the overall leverage, or coverage, as against the fund's investors in general) and the other is a more “U.S.” approach (increasingly adopted also in Europe and Asia) where the investor commitments are rated using (in broad terms) a ratings model. It is worth noting that in Europe, at least, both models remain current, with certain lenders (particularly where the facilities are bilateral) continuing to work with the leverage/coverage model and others (whether in bilateral or clubbed deals) tending to adopt the ratings model (commonly referred to – and described in the relevant loan agreements – as a “Borrowing Base”).

So, first, what is a “leverage/coverage” model and how does it work? In broad terms, this model takes the entire investor base and then applies a ratio (determined by credit appetite) of indebtedness (usually both specific to the facility and total indebtedness) to uncalled/uncommitted investor commitments generally. The ratios in terms of the facility will vary considerably depending on the make-up of the investor base, between a range of around 1.8:1 to 1.2:1. Considerations that will affect this, in particular, are the geographical spread of the investor base, the numbers of investors and their concentrations, and the extent to which the investor base consists of individuals or family offices as opposed to corporate, sovereign wealth or pension funds. Similar to a “borrowing base” model, certain investors will be excluded (*i.e.*, will not count towards the leverage/coverage ratio) to the extent that events occur to such investors which are likely to call their ability or willingness to meet their commitments into question. Often (and in contrast to a “borrowing base” model) the inclusion of a leverage/coverage model will be accompanied by a significant degree of discretion on the part of the lenders as to which investors (in particular, where there are investor transfers) to accept into and count towards the leverage/coverage ratios. In some transactions, lenders may agree the ratio may be subject to (downward) ratchets, usually based on either or both of percentages of paid-in commitments and/or, where the facility contains covenants relating to asset or investment NAVs, increases in the NAV of such investments.

In contrast to a “leverage/coverage” model, while a “borrowing base” model will look at the entire investor base, it will then apply different advance rates to different categories of investor based as stated in the introduction on a combination of external and internal ratings, and some investors (which do not meet any relevant ratings criteria) can be excluded from the borrowing base altogether. Exclusion of investors from a borrowing base model on this basis has nothing to do with their perceived inability or unwillingness to pay (as mentioned in the paragraph above, investors will also be excluded for this reason from a “borrowing base” model). In general, a borrowing base will allow somewhere around 90% or above as an advance rate against the “top rated” investors, then scaling down to around 60/65% for investors which are on a lesser rating, and then down again to as little as 5% to investors with inferior ratings or investors which are not rated. In addition to separate advance rates, a “borrowing base” model will also generally include specific concentration limits for different categories of investor, so as to ensure that facility limits cannot be “skewed” by including excess concentrations of particular types of investor. The “borrowing base” will also commonly include a “quasi ratings” advance rate for investors which may have significant financial standing but not have a formal public rating (for example, certain types of corporate entity). Because the “borrowing base” model is much more dependent on ratings and formulae for the inclusion or exclusion of investors, it is (in contrast to a leverage/coverage model) somewhat rare for lenders to be in a position to exercise discretion on the admission of new/transferee rated or credit supported investors to the borrowing base. They will usually be included (or excluded) automatically based on the specific borrowing base criteria as laid out in the facility.

Leaving aside specific policy or other guidelines (which will often dictate following one model or the other, and usually the “borrowing base” model), the choice of which model to use (leverage/coverage or borrowing base) will depend from the lender's side on the general investor profile. From the fund's side, the question is whether one or the other model might lead to a significantly different result in terms of the size of the available facility. Funds will also consider the level at which the fund may be anticipating transfers as between investors in the fund and the extent to which therefore the relative “certainty” of the “borrowing base” model and the ability to apply it to transferees may override the slightly less certain “leverage/coverage” model.

## Player Profile — Mike Breaux

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Player Profile



FFF: How did you end up in fund finance?

Mike Breaux: Like many others, I ended up in fund finance by coincidence. While working in the credit department at my previous bank, I was approached to fill a recent departure in the fund finance group. The concept of bridging capital calls with a line of credit seemed to make a lot sense, so I dove straight in, and the rest is history.

FFF: First half private equity fundraising reportedly came in at a four-year low. Do you think this is temporary?

Mike Breaux: Looking at the data, it was a very modest drop from 1H 2018. It certainly feels cyclical and not indicative of any larger trend. I'm keeping an eye on potential headwinds, though, including the political dialogue around private equity going into the 2020 election.

FFF: Do you see this slowdown affecting the fund finance activity at Stifel?

Mike Breaux: Definitely not. Of all the funds I talk to, the appetite for fund-level borrowing is either increasing or staying the same, but never reversing. This has led to a wide array of opportunities, both subscription and asset based.

FFF: Performance reporting seems to be receiving constant attention as of late. In May, Warren Buffett made some unflattering comments about fund reporting. More recently, we've seen advocacy in favor of reporting hypothetical ex-facility IRRs. What matters most here for lenders?

Mike Breaux: I think lenders need to keep doing their part to encourage and facilitate GP/LP transparency. Keeping loan terms clear and unambiguous is a given. Lenders can also provide a granular system of record data to allow GPs to easily query ex-facility IRRs and other metrics.

FFF: What advice do you have for the young fund finance banker just getting underway in the sector?

Mike Breaux: Embrace it! Fund finance is a great forward-looking industry. Transacting at the fund level typically means you get exposure to a wider breadth of underlying asset classes and fund strategies than you would in other career paths.

FFF: If you could give the Fund Finance Association one piece of advice, what would it be?

Mike Breaux: Keep the conference in Miami! The 2019 symposium was great. Otherwise, just keep the content fresh with perspectives across many different institutions, especially now that we have a record number of players in the space. And I know it's hard in such an opaque industry, but any efforts to produce metadata on fund finance, such as the FFA survey, is much appreciated.

FFF: Tell us what do you enjoy doing outside of the office?

Mike Breaux: I've been playing a lot of beach volleyball lately! Although my jump serve still needs some work.

FFF: Any bold fund finance predictions for the rest of the year?

Mike Breaux: Competition will continue to increase as new entrants become established – ultimately providing better offerings for sponsors. Fund-level financing will continue to inch its way up the list of LP-facing topics in order of importance, leading to more transparency, which is a win-win for everyone involved.



## What We are Reading on Private Markets

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**EQT and BC Partners.** Liquidity challenges for GPs when financing their “skin-in-the-game” commitments was back in the spotlight this week, with the *FT* reporting that EQT is apparently considering a public listing to raise fresh funds and BC Partners agreeing to sell a minority stake in its fund to Blackstone’s Strategic Capital Group to raise capital for future fund raises.

**Secondaries continue to boom.** Evercore reported that private equity fund and asset sales amounted to \$42bn in H1 2019, a 30% increase on the same period in 2018, with expectations that this year will beat last year’s record \$72bn of secondary transactions. The percentage of transactions constituted by GP-led deals has also increased from 29% in H1 2018 to 42% in H1 2019.

**European deal slow down.** Amid continuing political uncertainty in Europe, PE deal volume declined by 22% to EUR132.6bn from EUR162.3bn in the same period in 2018. The UK and Ireland continue to be the most active, accounting for more than a third of deal volume as GPs; however, deal value is at a five-year low, driven by GPs adopting a wait-and-see strategy pending further clarity around Brexit.

**Manulife** has sold \$1.7bn of its PE portfolio to a new vehicle backed by Alpinvest Partners and managed by its own PE investment, *Secondaries Investor* reported this week, repeating a similar transaction last year for Canada’s largest insurer.

## On the Move — Fund Finance Tidbits

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### On the Move

Barbara Fleming has joined Grasshopper Bank as Head of Venture Capital and Private Equity Relationships. Grasshopper Bank is a new commercial venture bank built for innovation economy companies and the venture capital firms that fund such companies.

Prior to joining Grasshopper, Barbara helped launch and expand the private equity and venture capital direct lending group at Bridge Bank. She has over 30 years of experience in a variety of business development-focused banking roles. Read the full press release [here](#).

## Fund Finance Hiring

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Fund Finance Hiring

East West Bank is currently seeking a senior Relationship Manager for its Private Equity business in the Eastern U.S. The Relationship Manager will work with other relationship team members in sourcing new business, structuring and underwriting loans, and managing relationships with a variety of private capital firms. For more information or to apply, click [here](#).

If you have an opportunity you would like posted on *Fund Finance Friday*, email us at [fund-finance-friday@cwt.com](mailto:fund-finance-friday@cwt.com).

