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FINANCE FORUM

Cadwalader Finance Forum

November 8, 2017

The Ritz Carlton Charlotte

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Brexit & European Market Update

Jeremy Cross

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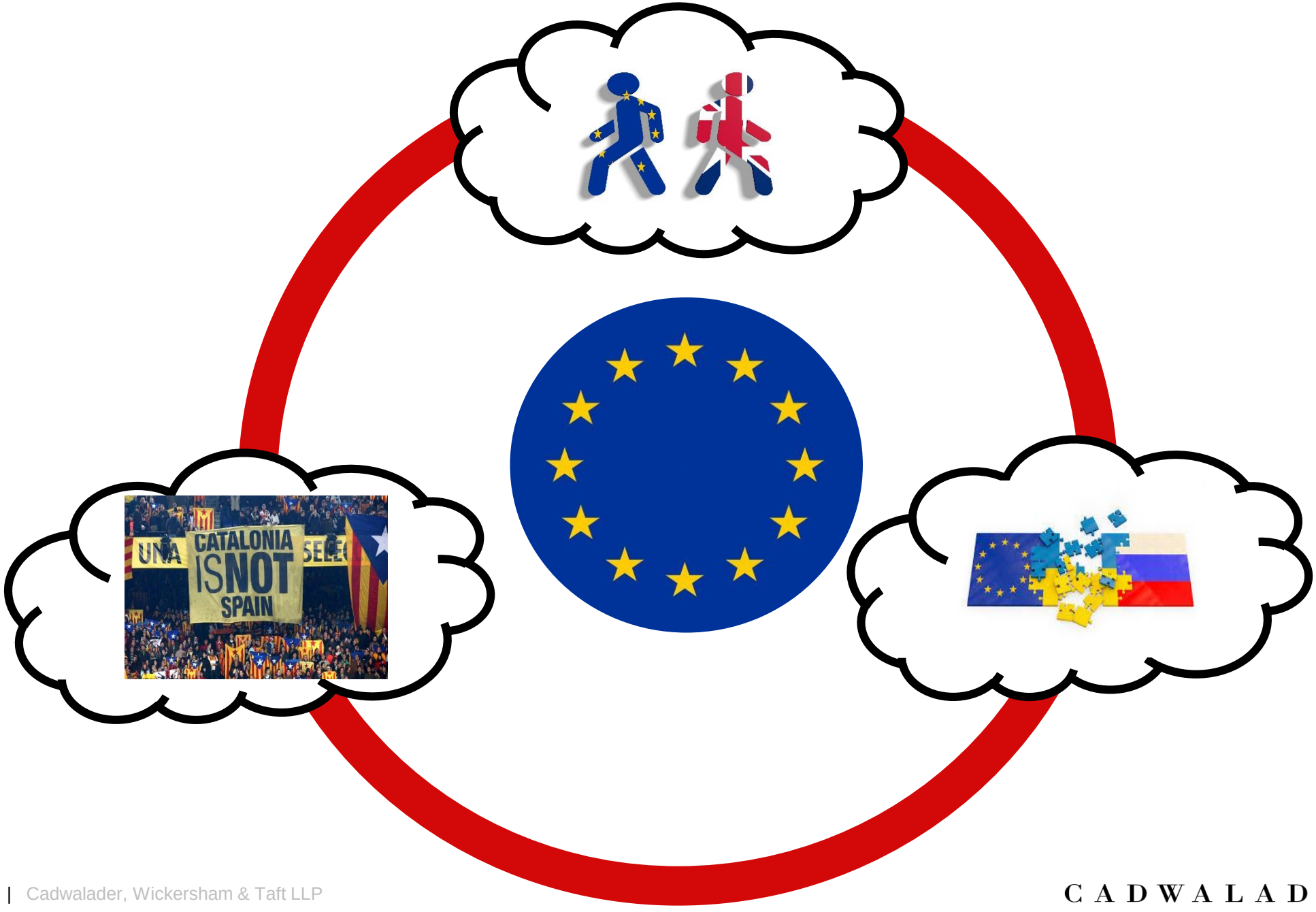
Brexit and European market update

Jeremy Cross
Partner

8 November 2017

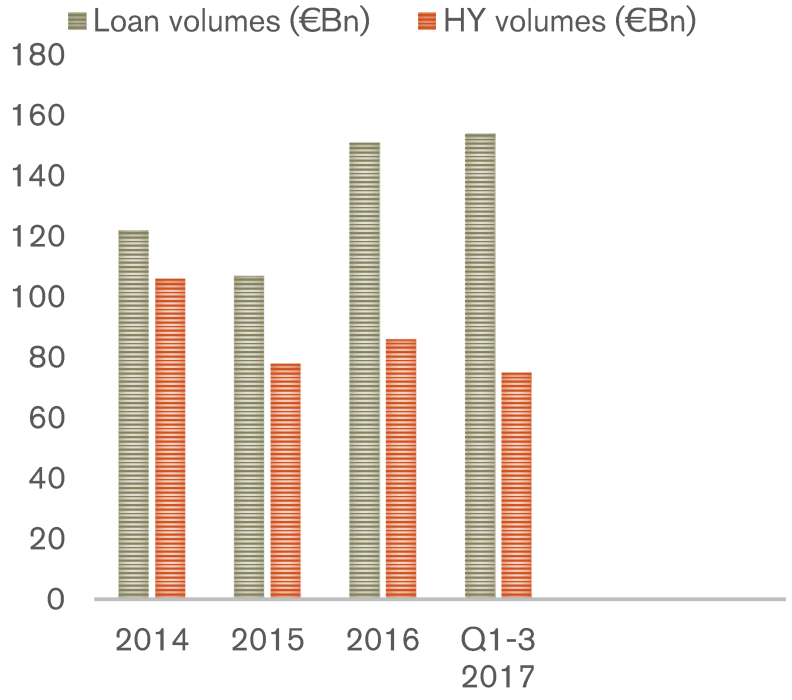
Brexit



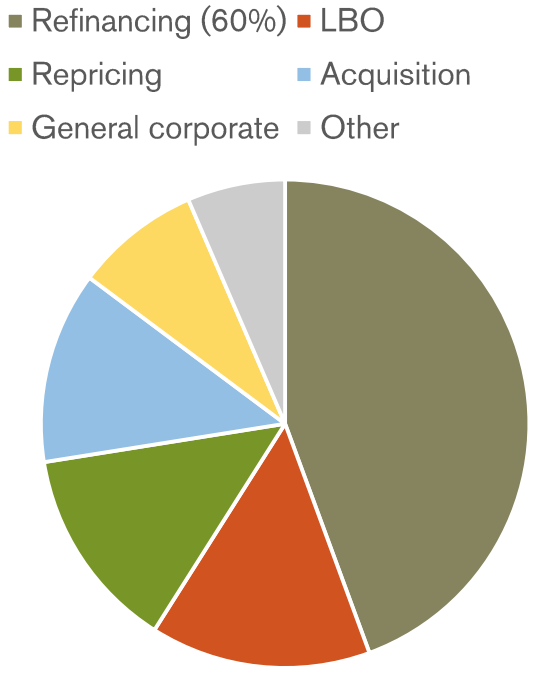
State of the market – leveraged finance

- Leveraged loan issuance in first three quarters of 2017 has surpassed 2016 full year volumes
- Leverage loan share of market continues to trend higher
- Market strengthened by refinancing trend, nearly 60% of volumes to date
- Reverse yankee issuance increase €16.9bn YTD

Leveraged Finance Volumes



Use of proceeds



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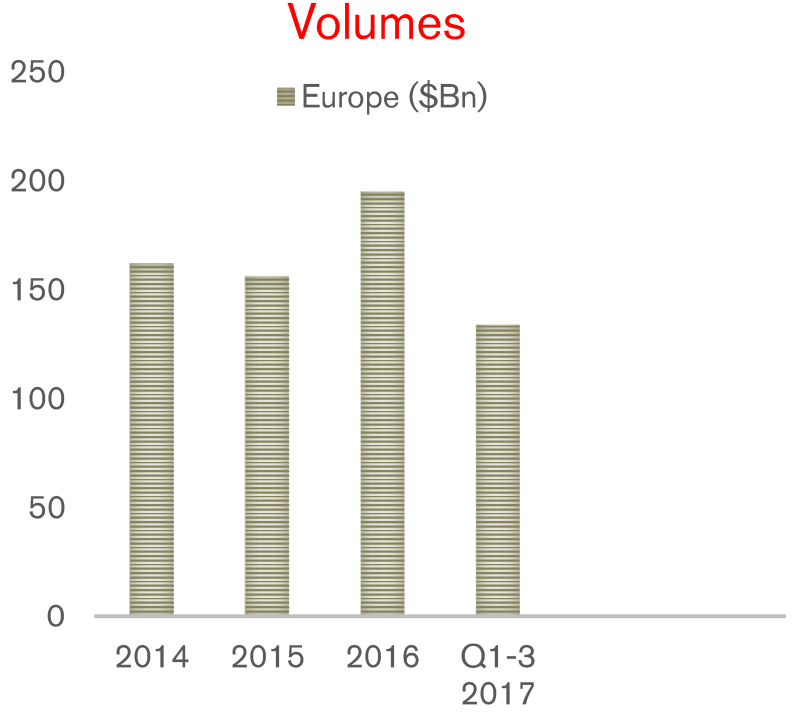
State of the market – funds

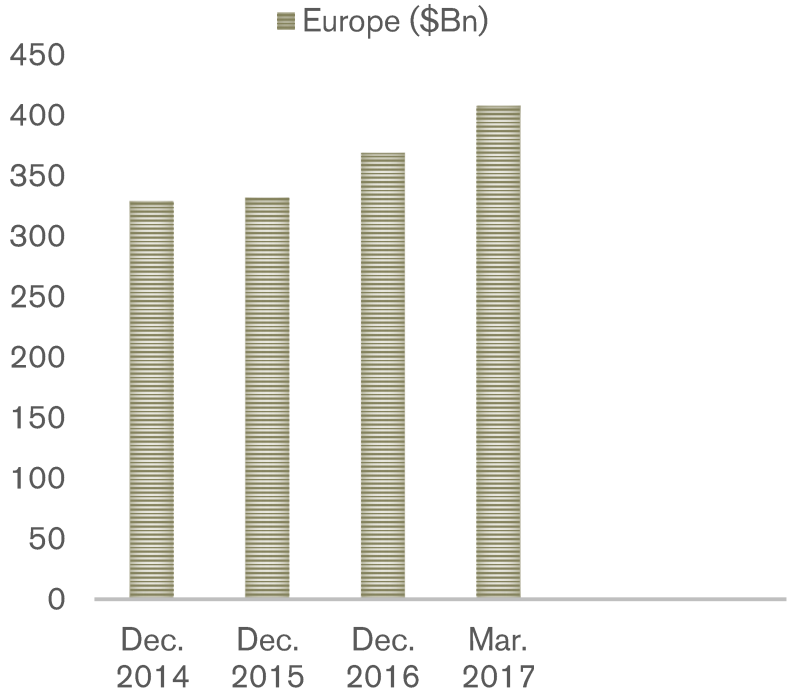
- European focused private capital fundraisings back at pre-financial crisis levels
- Estimated $134bn raised in first three quarters of 2017

European Fundraising Volumes



- Record levels of capital to invest
- European focused dry powder as much as $408bn at the end of Q1 2017

European Dry Powder



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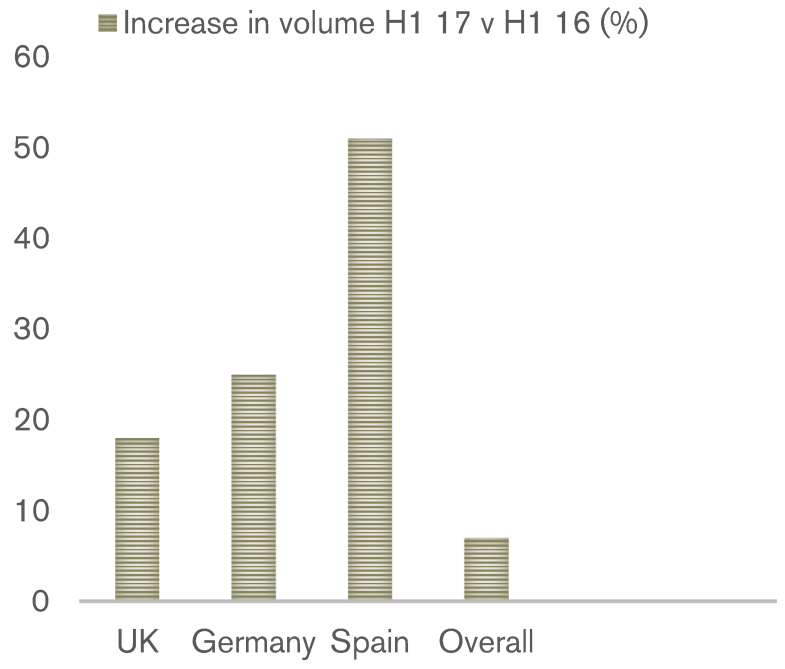
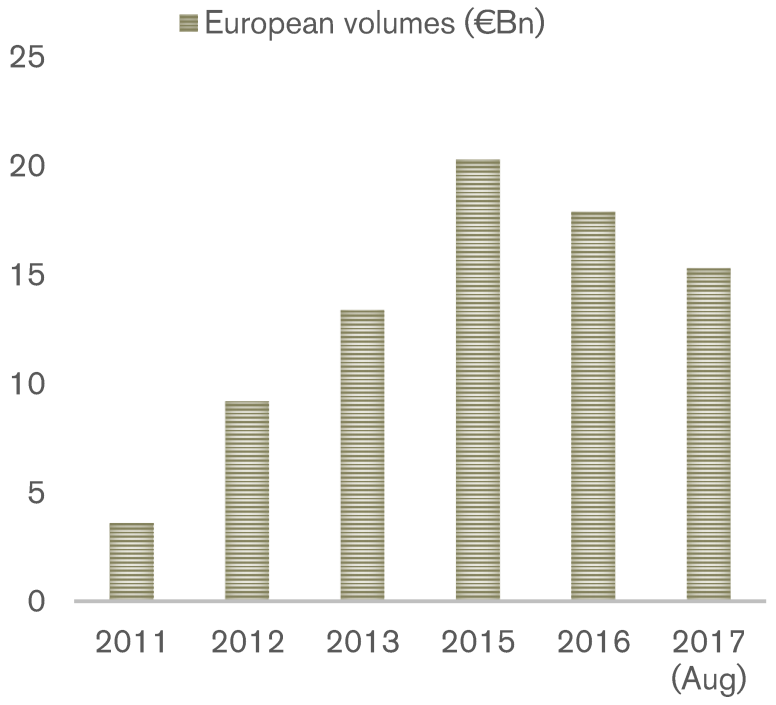
State of the market – real estate financing

- European focused private capital fundraisings back at pre-financial crisis levels
- Estimated $134bn raised in first three quarters of 2017
- Upsurge in bond market financing in real estate sector

Key Jurisdiction Investment



Bond Market Volumes



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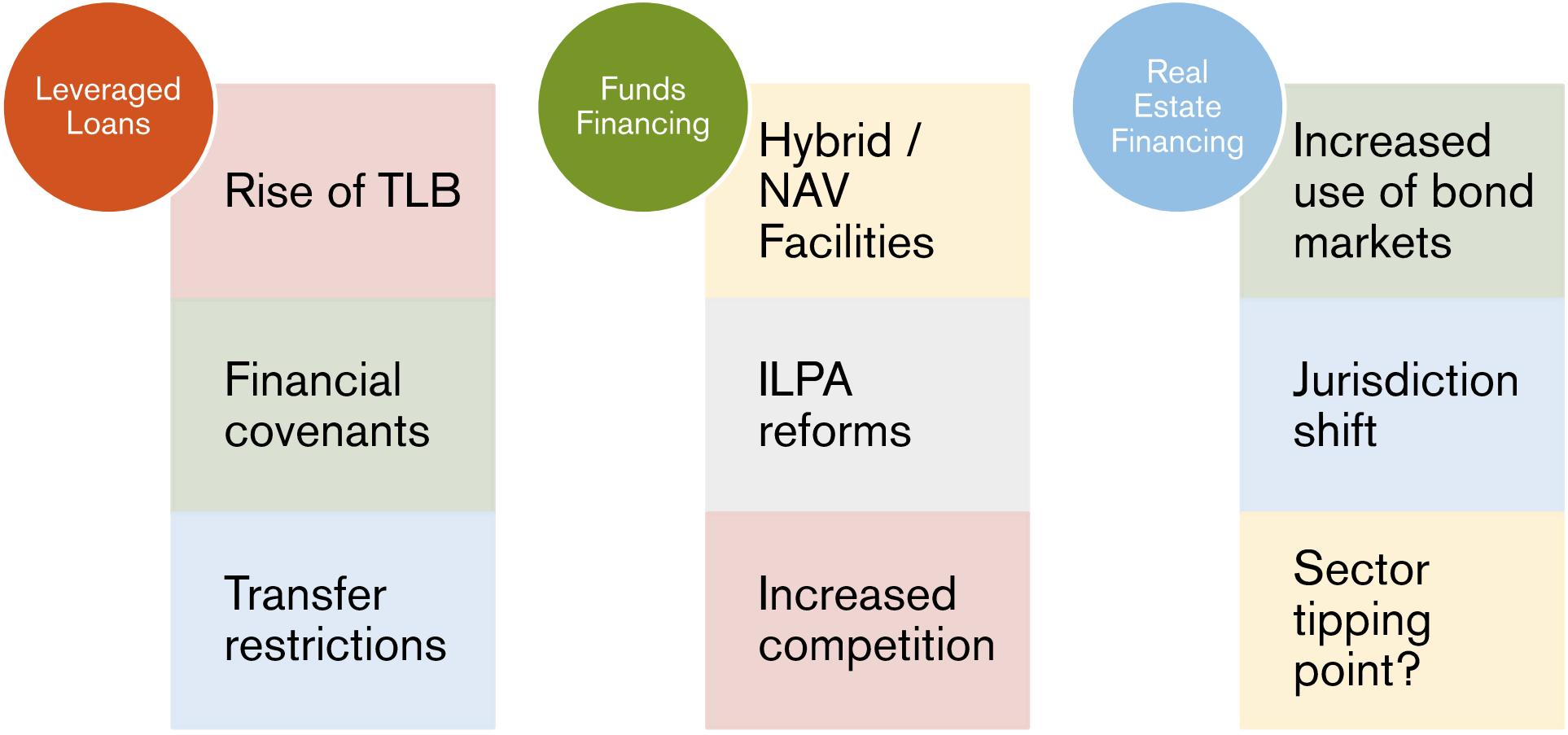
Market trends in 2017



Jeremy Cross

Jeremy Cross
Partner
London Office
+44 (0) 20 7170 8530
jeremy.cross@cwt.com

Jeremy Cross is a vastly experienced funds finance lawyer and has been active in the UK funds finance market (acting for both lenders and funds) for over 14 years.

During that time he has worked with most of the major lenders in the market, including Royal Bank of Scotland, Lloyds Banking Group, Barclays Bank, Wells Fargo, Bank of America, National Australia Bank, CACEIS and CBA along with a number of other banks, non bank financial institutions and funds. In addition to his "UK" experience Jeremy has also worked frequently on "US" funds financing structures and documentation.

Chambers UK lists Jeremy as a leader in the field of Banking & Finance, described as “a highly intelligent and commercial figure.” Legal 500 has recommended the “very commercial [Jeremy Cross].” He is also recommended in Bank Lending, noted as “very commercial and has the ability to explain in simple language often difficult concepts.” Jeremy was included among the “Hot 100”’ Lawyers by The Lawyer in 2013.

He was awarded an Exhibition to and received his M.A. in Law from Cambridge University. Jeremy is admitted to practice in England and Wales.

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Blockchain and Commercial Finance: New Technologies; New Opportunities

Jeffrey Nagle

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Blockchain and Commercial Finance: New Technologies, New Opportunities

November 8, 2017

PANELISTS

Moderator

Jeffrey Nagle
Partner, Finance
Cadwalader, Wickersham & Taft LLP

Kevin Batteh
Partner
Delta Strategy Group

Joan Cheney
Senior Manager
Deloitte

Christopher McDermott
Partner, Finance
Cadwalader, Wickersham & Taft LLP

TOPICS

- Introduction to Blockchain
- Uses of Blockchain Technology to Date
- Potential Applications of Blockchain Technology in Financial Services
- Legal, Regulatory and Other Issues
- Q&A

Introduction to Blockchain

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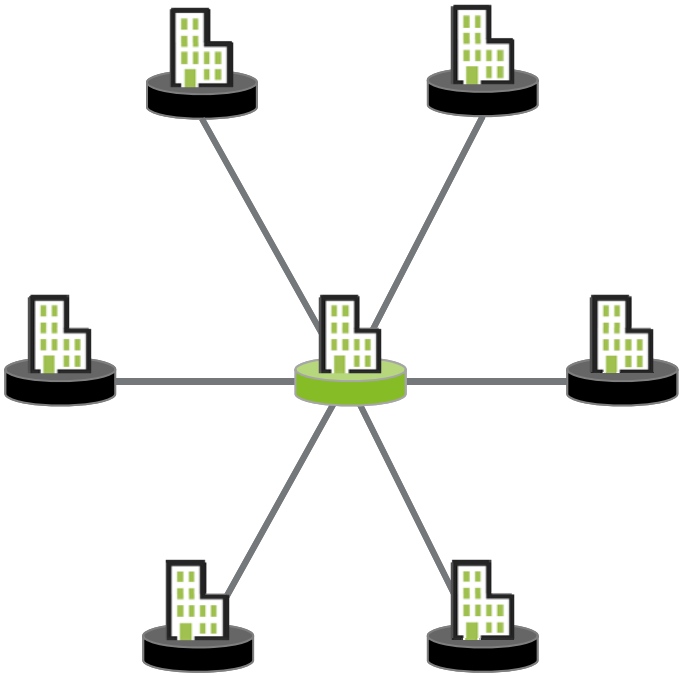
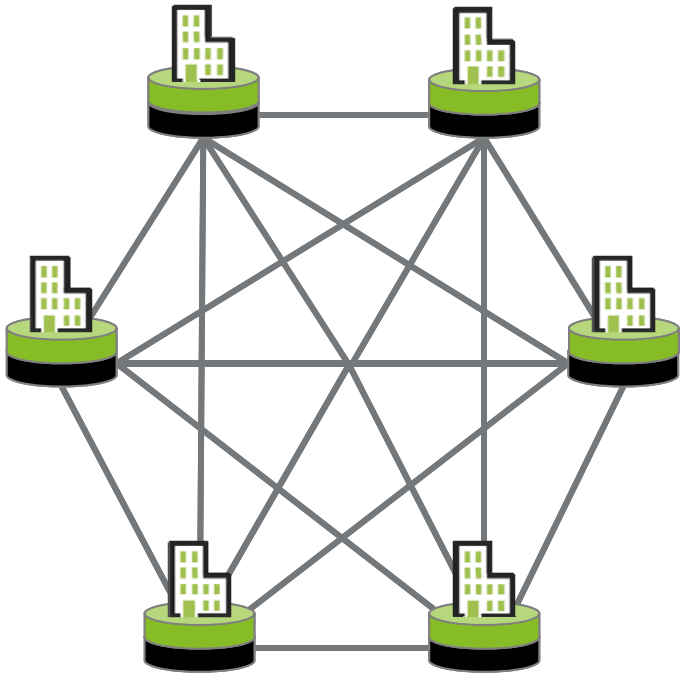
BLOCKCHAIN: THE FINANCIAL INFRASTRUCTURE OF THE OPEN DIGITAL ECONOMY



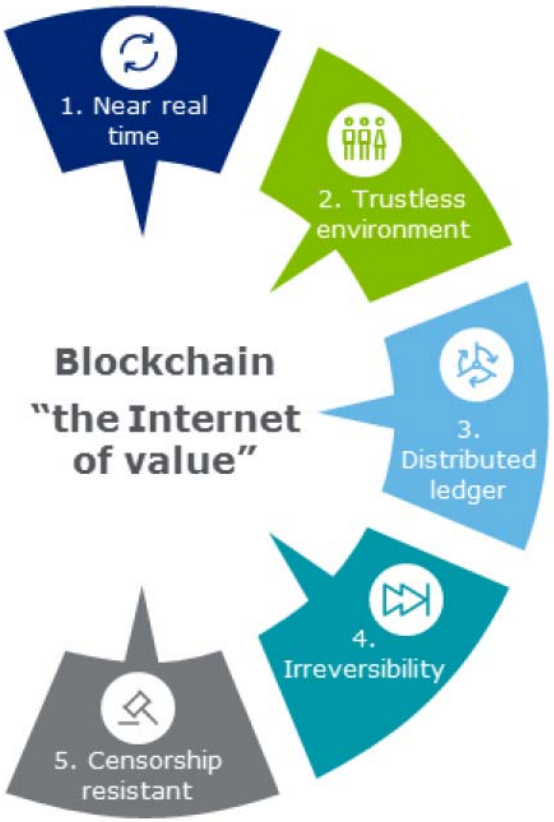
Centralized



Decentralized

WHAT IS BLOCKCHAIN?

Fundamentally, it is a digital ledger system for recording business transactions and events.



Near real-time
The blockchain enables the near real time settlement of recorded transactions, removing friction and reducing risk, but also limiting ability to charge back or cancel transactions.

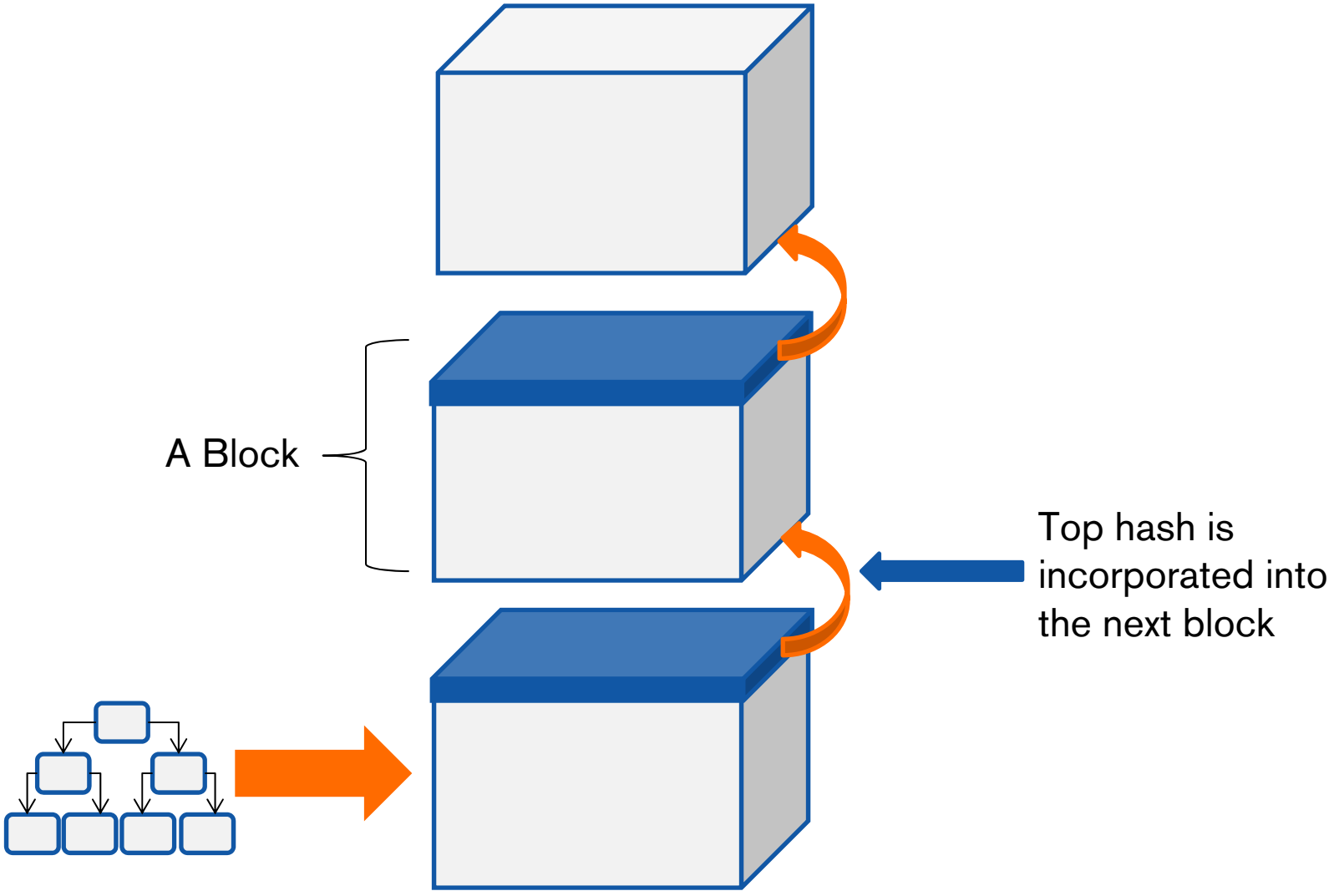
Trustless environment
Blockchain technology is based on cryptographic proof, allowing any two parties to transact directly with each other without the need for a trusted third party.

Distributed ledger
The peer-to-peer distributed network records a public history of transactions. The blockchain is distributed and highly available. The blockchain retains a secure source of proof that the transaction occurred.

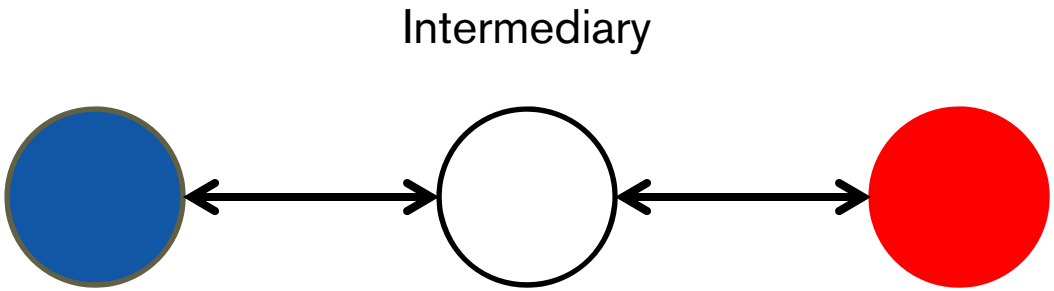
Irreversibility
The blockchain contains a certain and verifiable record of every single transaction ever made. This mitigates the risk of double-spending, fraud, abuse, and manipulation of transactions.

Censorship resistant
The crypto-economics built into the blockchain model provide incentives for the participants to continue validating blocks, reducing the possibility of external influencers to modify previously recorded transaction records.

WHAT IS BLOCKCHAIN? (CONT'D)



BEFORE DISTRIBUTED LEDGER TECHNOLOGY ("DLT")



Trust is placed in intermediaries to facilitate transactions.

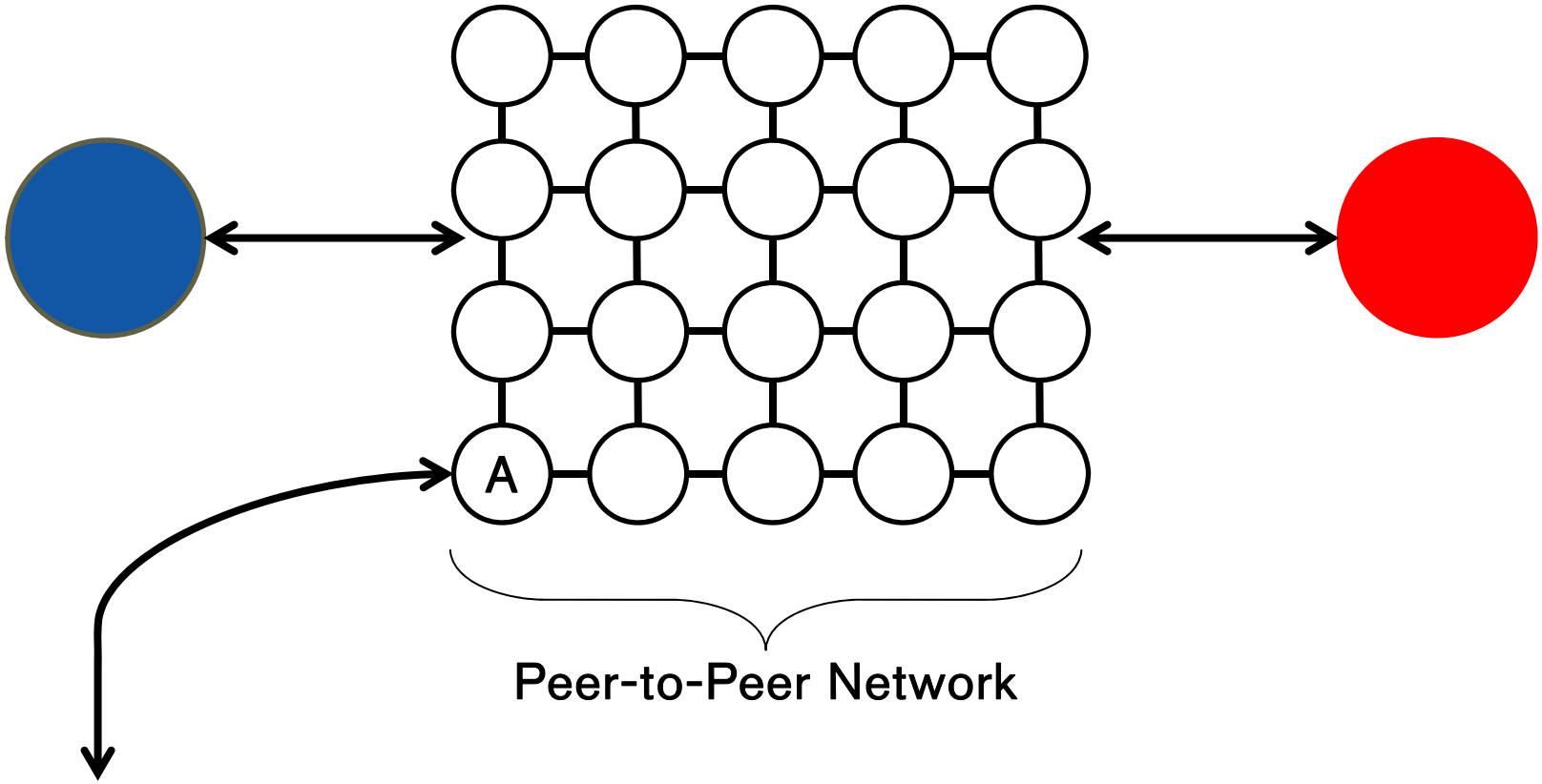
Roles Shifted to Intermediaries

- Onboarding
- Negotiation
- Execution
- Confirmation
- Collateral Exchange
- Reconciliation
- Trade Reporting
- Recordkeeping
- Amendments
- Testing
- Transportation
- Storage
- Settlement
- Payment

New Hurdles and Risks Related to Intermediary

- Fraud
- Mistakes
- Theft / Conversion
- Insolvency
- Disasters
- Lesser Degree of Care (in practice)

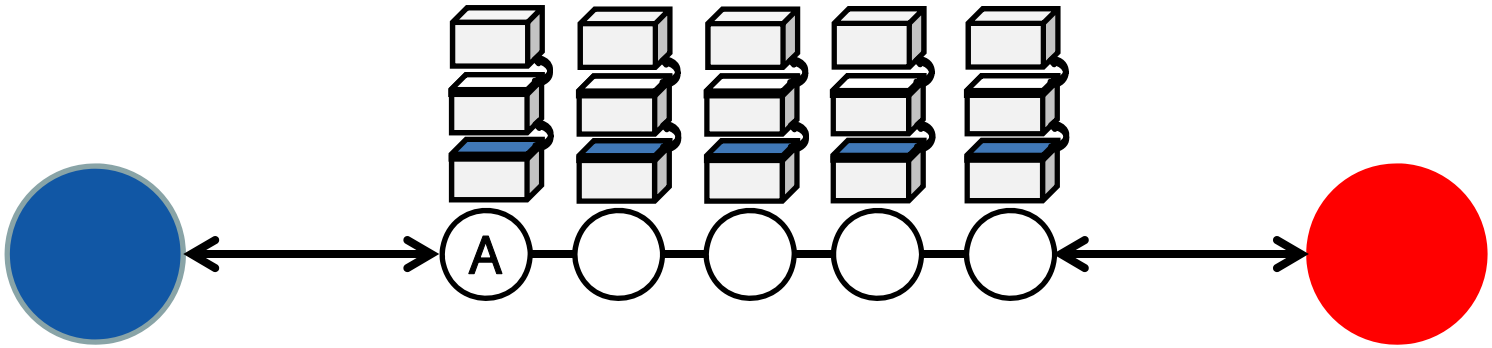
DLT IDEALIZED



A Node = Individual Server

Each node has an entire copy of the database (with records of all of the transactions) which the node continually updates and reconciles with each other node in the network. The result is a "distributed ledger."

DLT IDEALIZED (CONT'D)



1. Digitally signed transaction initiated
2. Transaction sent to miner who verifies transaction
3. Transaction is broadcast to all connected nodes as a block
4. Network accepts transaction if data is valid
5. Principal receives the transaction

ADVANTAGES OF DLT

- Weaves together functions of several intermediaries
  - *E.g.*, collateral management and reporting
- Continual verification and reconciliation
  - Prevents fraud
  - Protects and maintains data
  - Creates a “Golden Ledger”
- Removes problem of infinite reproducibility
- Can create contracts that have self-execution functionality
- Regulator potentially can “pull” information in lieu of parties reporting it

DLT – PERMISSION

- A blockchain can be:
  - "Permissionless" and open (*e.g.*, digital currencies);
  - "Permissioned," run by a trusted intermediary and accessible only to those with the necessary keys; or
  - A hybrid of both (built on public DLT infrastructure but with technology for permissioned networks)

Uses of Blockchain Technology to Date

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RECENT DEVELOPMENTS

- Most active sector in blockchain development: banks and stock exchanges
  - Majority of top banks engaged in blockchain proofs-of-concept
- Cross-industry consortia and partnerships also playing a large role in blockchain development and standardization
  - R3
  - Hyperledger Project
  - Project ConsenSys

EXAMPLES OF BLOCKCHAIN USES TO DATE

- Initial Coin Offerings ("ICOs")
- Cotton Trading Platform with Wells Fargo and Commonwealth Bank of Australia
- Oil Trading Platform with Mercuria, ING and Société Générale
- Oil Trading Platform with IBM, Natixis and Trafigura
- Trade Finance Platform with IBM, UBS, Bank of Montreal (BMO), CaixaBank, Commerzbank and Erste Group
- Letters of Credit with Kotak Mahindra Bank in India
- Proof of Concept with Hong Kong Monetary Authority

WHEN IS BLOCKCHAIN THE RIGHT FIT?

There are a handful of requirements that, when met in part or in full, should indicate whether blockchain can sufficiently address a client's needs.

 Shared Data	**Structured repository** of information.
 Multiple Writers	**More than one entity** generating the transactions that modify the database.
 Absence of Trust	Level of **mistrust between the entities** writing to the database (*e.g.*, one user will not accept the "truth" as reported by another user).
 Opportunity for Disintermediation	**Lack of trusted intermediary** or central gatekeeper to verify transactions.
 Transaction Interaction	Interaction or **dependency between the transactions created by different entities.**

OTHER INDUSTRIES' DEVELOPMENTS

- Payment Systems
  - MasterCard: blockchain-based APIs
- Music Industry
  - Royalty payments; selling music directly to fans
- Real Estate
  - Sweden and Georgia land / property registries
- Insurance
  - Asset micro-insurance for sharing economy
- Healthcare
  - Blockchain-enabled platforms for data storage and verification

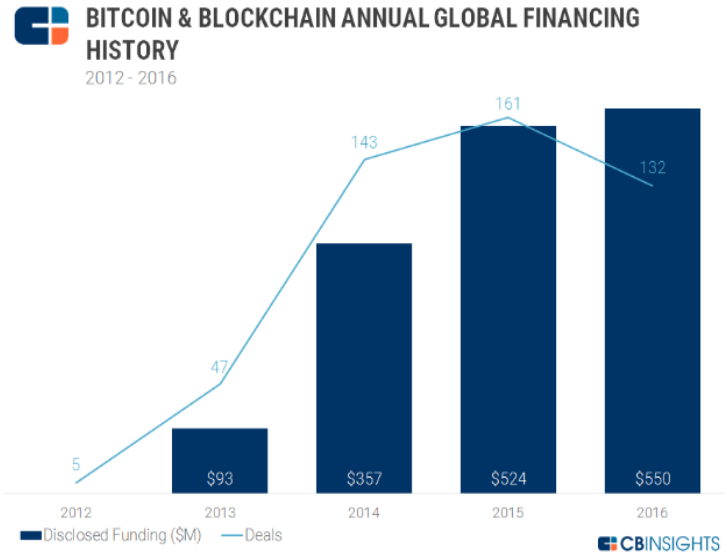
INVESTMENTS ON BLOCKCHAIN-BASED STARTUPS CONTINUE TO INCREASE

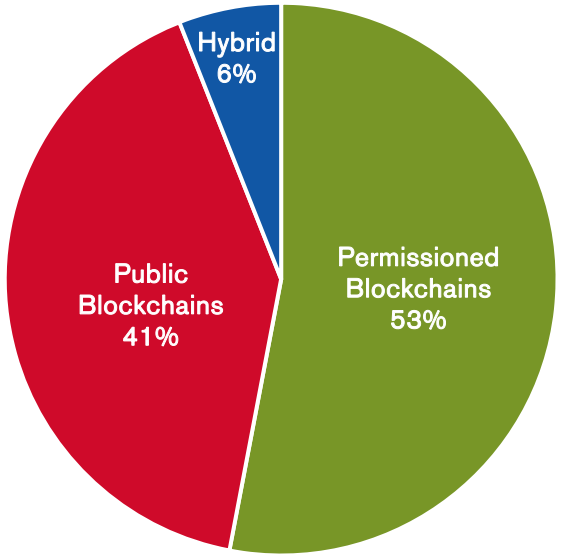
~$1.5B
In VC investments in past 4 years

~80%
of the world's largest banks have initiated Blockchain projects

~2500
Patents filed in the last three years in tech innovation, a surge of 83% from the prior three years

~10%
Assets on blockchain by 2025





Source: Coindesk

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Potential Applications of Blockchain Technology

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BLOCKCHAIN USE CASES

Numerous use cases for blockchain have already been identified.

Transfer of Value

Blockchain can efficiently facilitate transfers on peer-to-peer, business-to-business, and computer-to-computer transactions for minimal cost

Cross Border Payments

Blockchain can transfer payment across currencies almost instantly for a fraction of today's cost and provide access to the unbanked in remote areas

Digital Identity

Blockchain can create an auditable source of information shared and verified across a network of organizations (e.g., know your customer or KYC compliance)

Clearing and Settlement

Blockchain shows promise to drive efficiency in the clearing and settlement process of digital assets

Provenance

Blockchain offers an immutable and irreversible source of information that can track the true ownership of a product across the supply chain

Multi Party Aggregation

Blockchain can be used as a shared master data repository for common industry information allowing members to query the data

Record Keeping

Blockchain provides a method for collectively recording and notarizing any type of data, whose meaning can be financial or otherwise

Smart Contracts

Contractual terms and obligations can be programmed directly into the blockchain, maximizing adherence (*e.g.,* syndicated loans, derivatives)

SOME POTENTIAL APPLICATIONS TO FINANCIAL SERVICES

- Trade and Commodities Finance and Other Forms of Asset-Based Lending
- Loan Syndication and Trading
- Securitization
- KYC/AML
- Stock Ownership
- Payment Systems

PHYSICAL AND FINANCIAL TRADING

- In both physical and financial trading, DLT has the potential to perform principally five functions:
  - Fraud Protection
  - Disintermediation
  - Record Retention
  - Smart Contracts
  - Regulatory Monitoring

DISINTERMEDIATION

- Registry Maintenance
- Execution
- Confirmation
- Collateral / Exchange
- Reconciliation
- Trade Reporting
- Life Cycle Events
- Settlement

DERIVATIVES TRADING

- Blockchain technology may disrupt but not wholly replace the role of central counterparties ("CCPs")
- The following CCP roles may be performed by DLT:
  - Contract valuation
  - Variation margin payment settlement
  - Initial margin calculation and custody
  - Novation / netting
  - Close-out on default
- DLT may transform and revive the OTC derivatives market by providing a transparent alternative to CCP trading

COMMODITIES TRADING

- Qingdao port scandal
  - Evidence of the need for reform
- Other potential uses
  - Distributed smart grid (houses can generate and sell their own electricity)
  - Documents of title
  - Renewable credits trading

Legal, Regulatory and Other Issues

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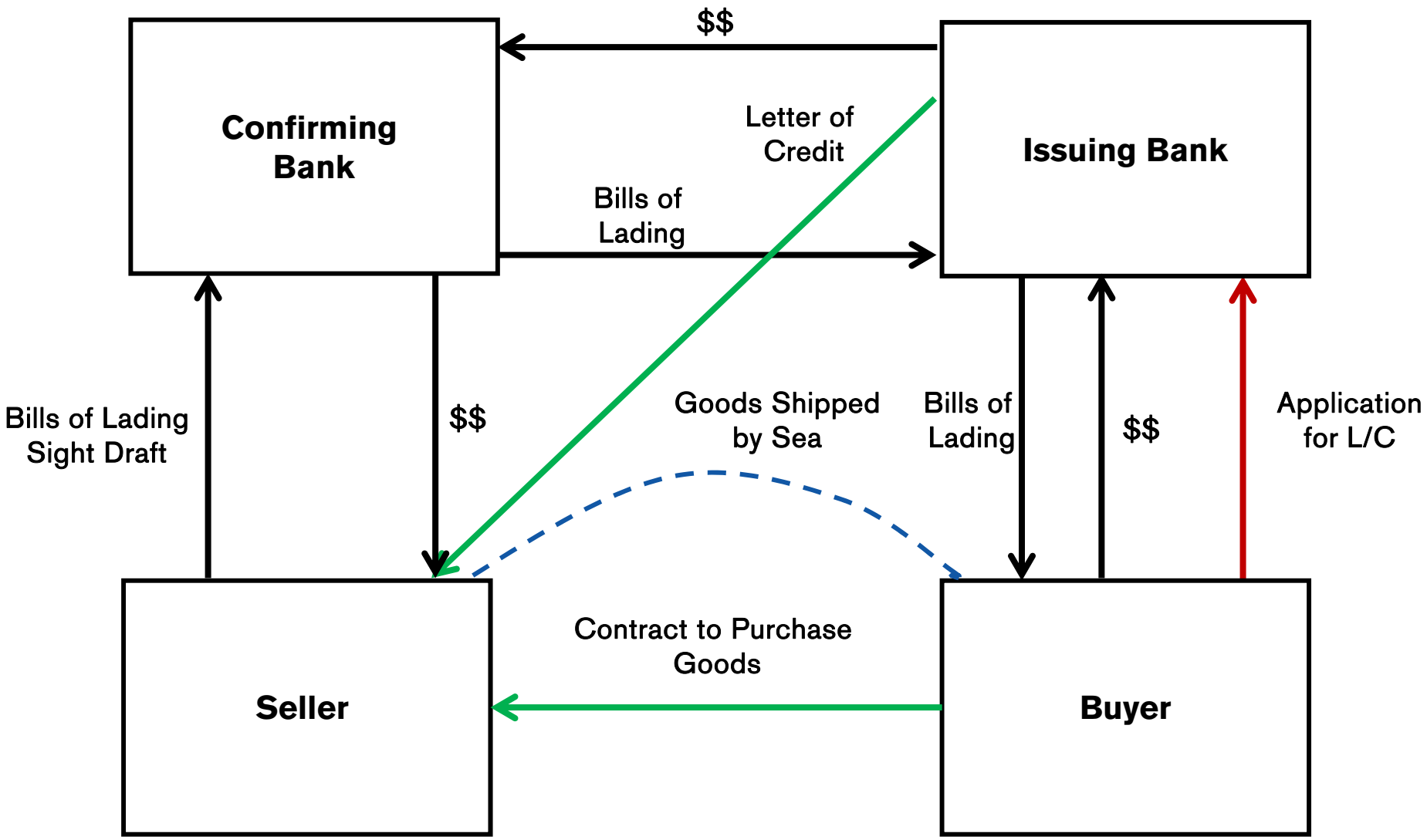
BLOCKCHAIN TECHNOLOGY AND THE UNIFORM COMMERCIAL CODE ("UCC")

- New Platforms Using Blockchain Technology in the US for Commercial Finance Transactions Must Still Meet the Existing Requirements of the UCC. For Example:
  - Deposit Account Control Agreements and Establishing "Control" for Purposes of UCC § 9-104
  - Bills of Lading and Documents of Title for Purposes of UCC § 1-201(6) and UCC § 9-201(16)
  - Letters of Credit and UCC § 5-104

SIMPLE COMMODITIES PURCHASE TRANSACTION



BLOCKCHAIN REGULATION – U.S.

- Currently, federal regulations and enforcement actions relate to bitcoin, not really blockchain
- CFTC
  - CFTC Technology Advisory Committee meeting
  - LabCFTC
  - Chairman Giancarlo: regulators should avoid “undue restrictions” on blockchain innovation
  - Bitfinex - $75K settlement for bitcoin exchange for failure to register as an FCM
- SEC
  - DLT Working Group
  - FinTech Forum
  - The DAO Investigative Report

BLOCKCHAIN REGULATION – INTERNATIONAL

- EU
  - ESMA Discussion Paper
  - EU Parliament: voted to take a "hands-off" approach toward blockchain tech regulation; EU Blockchain Observatory
- United Kingdom
  - FCA "Regulatory Sandbox"
  - FCA Discussion Paper
  - Blockchain-based social welfare payments
- Central banks are exploring blockchain technology
  - Monetary Authority of Singapore: testing its own digital currency
  - Reserve Bank of India: encouraged banks to develop applications for digital currencies and DLT
  - Bank of Canada: running experiments on interbank payment systems using DLT
  - Central Bank of Philippines: stated that it is considering how to regulate digital currency exchanges

WHAT BLOCKCHAIN WILL LIKELY NOT DO

- Perform Negotiation
  - Though may lead to further standardization
- Resolve Disputes
- Abate Certain Risks
  - Performance
  - Some credit risks
  - Change in law

BARRIERS TO IMPLEMENTATION

Challenge	Description	Potential Mitigation
Market Adoption	▪ A critical mass of individuals and organizations would need to participate in a Blockchain, or specific sidechain, to entice enough activity to make it viable for transactions	▪ Higher traction in adoption of this use case by big firms and individual investors
Evolving Technology	▪ Blockchain as a technology is still maturing and various platforms and applications are still evolving. A global standard does not yet exist	▪ Build with microservices so your solutions are portable
Integration with Legacy Systems and Processes	▪ To realize the full potential of operational benefits that Blockchain can offer, it must function in close collaboration with other peripheral systems	▪ Blockchain infrastructure that supports smooth linkage between multiple applications
Contract Flexibility	▪ Programming a smart contract requires a determination of the execution of events during the life of the investment at the onset of a transaction, and any change in regulations during the life of an investment reduces flexibility, unless provisions for an amendment were incorporated	▪ Pre-programmed recourse mechanisms, to allow for amendments
Legal and Regulatory Constraints	▪ Legal recognition of programmable contracts and digitally transferred assets in the court of law; lack of regulatory bodies approving applications of Blockchain technology for specific use cases	▪ Involving legal stakeholders and identifying and working with appropriate regualtory bodies from early stages

BLOCKCHAIN: WHAT THE FUTURE HOLDS

- Potential for failure: will the technology live up to the hype?
  - Security concerns (hacking, bugs – DAO Attack)
  - Industry participants need assurance about transaction anonymity and privacy
  - Cost savings and efficiency need to make initial investment worthwhile
  - Collaboration and standardization are necessary in order for DLT to be widely adopted
  - Regulatory contradictions or ambiguity could hinder advancement of the technology

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Bloomberg Law

BNA's
Banking Report™

Financial Technology

Using Blockchain to Replace Deposit Account Control Agreements



By Jeff Nagle, Chris McDermott and Michael Lynch

In a secured lending transaction, it is common for a lender to take security over a borrower's deposit accounts as part of its collateral package. In the United States, such security interest is commonly perfected under the Uniform Commercial Code (UCC) by the entrance of the secured party, the debtor and the third-party account bank at which the deposit account is maintained into a deposit account control agreement (a DACA). While effective to perfect a security interest, the process of entering into and maintaining DACAs, and complying with their various terms, can be burdensome on all parties involved.

Blockchain technology has been predicted by many to be potentially transformative across a wide variety of industries and functions. The financial services industry has been particularly active in early adoption (or at least testing) of blockchain applications. DACAs, and the related deposit account control ecosystem, are an enticing target for the application of blockchain technology.

We will take a closer look at the potential implementation of a blockchain structure on traditional DACAs below.

Traditional Deposit Account Control Agreements and Their Benefits

Like other forms of personal property, deposit accounts are generally subject to a lender's security interest by way of the granting clause in a security agreement. However, unlike many other forms of personal property, deposit accounts cannot be perfected under the UCC by filing a UCC-1 financing statement. Instead, the secured party must obtain ''control'' over the deposit accounts, as defined in UCC § 9-104. One common way to obtain control is for the secured party, the debtor and the third-party account bank at which the deposit account is maintained to enter into a DACA, pursuant to which the account bank agrees that it will comply with instructions originated by the secured party without further consent of the debtor. Frequently, DACAs incorporate ''shifting'' control, i.e., the account bank accepts instructions from the debtor with respect to the subject deposit account until it receives notice from the secured party that an event of default has occurred under the applicable credit documents, after which the account bank will only comply with instructions from the secured party.

 ISSN 0891-0634

Besides allowing a secured party to perfect its security interest in deposit accounts, DACAs can provide significant practical benefits. In particular, a DACA allows a secured party to obtain at the outset the account bank's consent to cooperate with the secured party during an enforcement on the deposit account. In addition, a DACA typically establishes the ways in which the parties will communicate with each other regarding the deposit account, and frequently provides form documents for doing so.

Blockchain Technology

In simple terms, blockchain is a type of shared database or ''distributed digital ledger'' for recording transactions or other information. Traditionally, ledgers were either centralized (kept by one entity) or decentralized (kept by multiple entities). Centralized ledgers require all participants to (1) trust that the ''keeper'' of the ledger has the sole, and correct, authoritative copy, and (2) suffer the risk of catastrophic failure if the ledger is corrupted. Likewise, the problems with decentralized ledgers become quickly apparent: different copies of the ledger could contain different data, making it difficult for multiple parties with varied interests to trust the ledgers of other members of the group.

With blockchain technology, a digital ledger storing information that is widely distributed seeks to address the problems of both centralized and decentralized ledgers. The ledger is held by many individual computers, called nodes. It is altered by the accumulation of ''blocks,'' each of which adds additional data to the data stream. New blocks must be validated by a set number of nodes. Once validated and added to the ''blockchain,'' it becomes very difficult (virtually impossible in any realistic scenario) to modify the information, as that would require sequentially modifying information held on disparate computers around the world. The information becomes immutable, easily accessed and verifiable.

Originally and most famously, blockchain technology was used in connection with the digital currency Bitcoin. More recently, its applicability to other fields has become apparent. Within the financial services industry in particular, it has been suggested that blockchain technology can be used in a variety of ways, including to record trades in the shares of privately held companies and to allow banks to better comply with ''know-your-customer'' and anti-money laundering regulations. There is, however, a key distinction between the use of blockchain technology for Bitcoin and its potential uses by banks and other financial institutions. While Bitcoin's blockchain ledger is publicly accessible, it is expected that blockchains in the financial services industry will typically be private or quasi-private—that is, only accessible within a single institution or by a defined set of trusted users from different institutions.

The Potential of Blockchain for DACAs

As applied to account control arrangements specifically, blockchain could offer a number of advantages over traditional DACAs. Although it is uncertain exactly how and to what extent blockchain will come to be used in this context, at minimum it seems that the technology could be used as a more efficient and reliable medium for parties to deliver notices to each other. That is, instead of delivering a control notice to the account bank via email or fax, which would then require the account bank to separately update its internal databases to reflect receipt of the notice, a secured party could simply update the relevant ledger and the account bank and debtor would immediately receive notice without further need to update internal databases. Yet using blockchain for the delivery of notices is low-hanging fruit. Like the transition from fax to emails, it would not significantly change the underlying fundamental structure of DACAs.

Used more ambitiously, however, blockchain may eventually eliminate traditional DACAs completely. For example, what if depositary banks began implementing their bilateral deposit account relationships with customers on blockchain? A customer needing to add a triparty control arrangement could have the parties write their terms into the blockchain itself or into a robot-like smart contract that rides atop the blockchain (rather than embodying the terms of the control agreement in a standalone document). Like using blockchain for delivering notices, this would likely increase efficiency and reduce uncertainty in the implementation of the parties' agreement while decreasing negotiation time at the outset. However, more significantly from a secured party's perspective, this approach may give additional bargaining power to account banks, making them less willing to modify their embedded blockchain code and negotiate tailored control arrangements.

Most account banks build one- or two-business day delay periods into traditional DACAs after delivery of a shifting control notice, during which the account bank is not obligated to cease complying with instructions from a debtor. This time period is designed to give account banks the operational time to fully shut down access to a debtor across the bank's cash management system and is viewed as an important risk management safeguard. However, the risk to a secured party during this delay period is that a debtor may have sufficient time to drain the affected deposit account. Given market constraints, most secured parties have reluctantly accepted these delay periods in DACAs as a fact of life. But with a properly designed blockchain construct, the determination of which party is authorized to give instructions on a deposit account under the triparty ''control'' mechanic could be seamlessly and automatically integrated with a bank's internal systems with no such delays. A technological upgrade that could get rid of this delay period would, therefore, be a significant credit enhancement for secured parties.

UCC Analysis

Suppose that a secured party has a valid security interest under the UCC in a deposit account, either via a traditional security agreement or, in the future, perhaps even a blockchain-based security agreement. In order for a blockchain-based control mechanism to work, it would need to fit within current legal constructs to accomplish ''control'' (and therefore ''perfection'') under the UCC. Our analysis below focuses on the technical provisions in the UCC to test whether our blockchain-based DACA replacement would meet these requirements.

The relevant provision under UCC § 9-104 that addresses establishment of control requires that the parties agree in an ''authenticated record'' that the account

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bank will comply with instructions originated by the secured party directing disposition of the funds in the deposit account without further consent by the debtor. The key to the UCC analysis would seem to be whether the agreement contained in the blockchain constitutes an ''authenticated record'' under the UCC.

To ''authenticate'' under UCC § 9-102(7) means in relevant part ''with present intent to adopt or accept a record, to attach to or logically associate with the record an electronic sound, symbol, or process.'' Assuming the parties do in fact presently intend to adopt an agreement, and leaving aside for the moment whether the blockchain code would constitute a ''record'' under the UCC, it would need to be established that an electronic sound, symbol or process is attached to or logically associated with such record, and this would likely be satisfied by the parties' use of private keys to accept the blockchain code.

A ''record'' under UCC § 9-102(70) is ''information . . . . which is stored in an electronic or other medium and is retrievable in perceivable form.'' In this case, such information (that is, the agreement as to who controls the deposit account and therefore has the right to give instructions) would be stored in an electronic medium (blockchain) and would likely also be ''retrievable,'' since one could access the information by looking at the relevant blockchain code. The information would also likely be ''perceivable,'' although this point may be somewhat less obvious. Unlike a PDF file of a written agreement, which becomes perceivable once it is opened with the proper computer program, it is not necessarily true, where the blockchain code itself is intended to embody the agreement, that it is ''perceivable'' to someone who is unable to read computer languages. On the other hand, it is more probably the case that the information need only be perceivable by a person in the abstract (that is, able to be perceived by someone, such as a blockchain programmer) rather than perceivable by each party to the agreement, since the definition of ''record'' does not make any reference to a particular agreement's parties. The blockchain-based control mechanism would seem to fit the UCC's concept of an ''authenticated record.''

Conclusion

Although it remains uncertain exactly how and to what extent blockchain technology will influence secured lending in the coming years, financial and legal professionals would benefit from considering its potential impact—since that impact could be more wide-ranging and fast-approaching than some currently believe. Given that a properly designed blockchain system can likely be accommodated within existing UCC provisions governing ''control'' over deposit accounts, such blockchain-based replacements for DACAs could have real and tangible benefits for secured parties, account banks and, ultimately, debtors.

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Jeff Nagle is a partner at Cadwalader, Wickersham & Taft LLP in Charlotte. His principal practice focuses on leveraged finance and other syndicated bank loan transactions, the financing of financial assets, distressed debt trading, asset-based lending, commodities financings, energy project financings and rescue financing, workouts, debtor-in-possession financings and exit financings.

Chris McDermott is a partner at Cadwalader, Wickersham & Taft LLP in Charlotte and New York. His principal practice involves the representation of commercial banks and other financial institutions in commercial lending and other financing transactions, including general secured and unsecured lending transactions, syndicated bank financings, refinancings, leveraged buy-outs and other acquisition financings, commodity, energy and other asset-based lending transactions, hedge fund financings, and distressed, debtor-in-possession and exit financings.

Michael Lynch is an associate in Cadwalader's Charlotte office. His practice focuses on leveraged finance and other bank loan transactions, including asset-based lending, commodities financings, hedge fund financings and acquisition financings.

Portfolio Media. Inc. | 111 West 19th Street, 5th Floor | New York, NY 10011 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

From Bills Of Lading To Blockchain Structures: Part 1

By **Christopher McDermott, Jeffrey Nagle, Martin Horowitz and Stephen Johnson**

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A bill of lading is an old form of legal document. Early progenitors of the bill of lading emerged in the seventeenth and eighteenth centuries as medieval trading practices yielded to more modern mercantilism.


Christopher McDermott

As merchants ceased embarking personally on ships to accompany their shipped goods, but instead entrusted the goods to the shipper to transport and deliver at their destination, those merchants needed a way to make tangible and transferable the right to receive the entrusted goods and the contract of carriage of those goods.


Jeffrey Nagle

When the merchant discovered he could send the receipt obtained from the ship's master and convey it ahead to the recipient of the goods, who could in turn present it to the shipper to prove his title and obtain delivery of the goods, the bill of lading as the document of title we know today was born.

The rules relating to bills of lading and other documents of title evolved over the centuries. Today, a patchwork of laws governs bills of lading in domestic and international commerce.[1] Under U.S. state law, the rules governing bills of lading and other documents of title are housed mainly in Article 7 of the Uniform Commercial Code[2], so this article will limit its inquiry to the rules under the UCC.


Martin Horowitz

Technological change — and of particular interest, the emergence of blockchain technology — is raising new questions about the future of this old instrument. Recent media accounts report collaborative ventures between traders and financial institutions using blockchain solutions to serve the functions of bills of lading.[3]


Stephen Johnson

But as these blockchain strategies become more accepted in commodities trade, it falls to lawyers to tackle the challenge of fitting the new blockchain structures into the existing legal concepts that evolved for traditional bills of lading. Modern bills of lading still perform the same basic functions as their ancient ancestors: they evidence the title to the goods being shipped, the contract of carriage and the right to receive and direct the disposition of those goods. The blockchain solutions emerging in commodities trading seem to have the same functions.

It is fair to ask, then, whether the same legal rules apply? Or put another way, if a blockchain structure acts like a bill of lading, is it a bill of lading under the UCC? And if it is not — or if the answer is unclear — what is it?

Description of Model Blockchain

Before we can usefully discuss the application of UCC rules to a blockchain structure, however, we need to describe a structure to put to the test. There are many variants of the basic blockchain concept,[4] and it is not obvious from media reports how the blockchain applications currently being tested are structured.

So for the purposes of this article, let's describe as a thought experiment a blockchain structure that we think is probably representative of current endeavors to use blockchain in the movement of goods through a supply chain.[5] At a high level, our model blockchain would be a decentralized, automated system for storing information about transactions between its members.

It would be "permissioned" — that is, participants in the model blockchain must be admitted by the existing members, and the general public would not have access. (Those members would presumably need to include the relevant community of merchants selling and buying the goods, the carriers who ship them and financial institutions that finance such transactions.)

Our model blockchain would not be anonymous. Each member would be able to identify any other by their digital signature, which a computer could match to a member's name.

The system would also be "trustless," in that no single party validates a transaction. Instead, transactions would be validated by the model blockchain's members. Each member's computer would verify basic facts to protect against fraud or double spending.

After validation, a transaction would be written into a block in the model blockchain. Data in a block would be encrypted such that it is nearly impossible to modify. This non-centralized verification system — the distributed ledger — is the basic innovation common to blockchain systems that gives them their wide usefulness.

In the model blockchain, the data for a shipment of goods would identify the transferor, the transferee, the carrier, the time of the transaction, what is transferred and any miscellaneous data the transferor decides to include as "metadata." Transaction data would be available only to members of the model blockchain.

We would further imagine that the real-world assets or rights dealt with on our model blockchain would be represented as digital coins (blockcoins). A blockcoin would essentially be a bitcoin, but would have no monetary value. It instead would represent the goods.[6] A blockcoin and the model blockchain would work together. The blockcoin would stand in for the goods covered, while the model blockchain would identify who controls the coin and thus has title to the goods.

Could Model Blockchain Constitute a UCC "Bill of Lading"?

The UCC sets forth a complex statutory system covering bills of lading, but much of the UCC's framework was drafted with paper bills of lading in mind. New concepts such as "electronic documents of title" have been grafted on to the pre-digital framework, but the basic structure still largely employs concepts

foreign to the electronic frontier, such as “bearer,” “issuer,” or “copy.”

How does that framework look when we map the model blockchain against the UCC’s mixture of old and new rules? Could our model blockchain system constitute a bill of lading under the UCC?

Under the UCC, a bill of lading is defined as (1) a document of title, (2) evidencing the receipt of goods for shipment, (3) issued by a person engaged in the business of directly or indirectly transporting or forwarding goods.[7] To answer this first question, we need to unpack this UCC definition.

Could a Blockchain System Constitute a Document of Title?

A document of title is defined in the UCC as (1) a record, (2) “that in the regular course of business or financing is treated as adequately evidencing ... [title to] the record and the goods the record covers,” and (3) that “purports to be issued by ... a bailee and to cover goods in the bailee’s possession.”[8]

1. “A record”

In the model blockchain, the transaction data — which includes the blockcoin — stored in a block would seem to clearly constitute a record. A record is “information ... that is stored in an electronic or other medium and is retrievable in perceivable form.”[9]

The transaction data in the model blockchain is stored in a computer (an electronic medium) and is retrievable in perceivable form when the data is displayed on a member’s computer monitor.

2. “In the regular course of business”

A carefully constructed blockchain system should satisfy the “regular course of business” requirement as well, at least over time. Courts have tested the idea of “regular course of business” by looking to established industry practice.[10]

While a disruptive new technology like blockchain may not initially be an established industry practice, as blockchain architectures gain acceptance for applications relating to the trading of goods, such objections should naturally evolve away.

Further, recent additions to the UCC providing for electronic documents of title suggest that the statutory scheme does not intend for this requirement to impede the development of new technologies.[11] To mitigate this risk, a transaction on our model blockchain might include — at least initially — a PDF of an executed industry standard bill of lading, linking the model blockchain back to more traditional, established industry standards.

3. “Purports to be issued by ... a bailee”

For the model blockchain to satisfy the requirement that the document of title purport to be issued by a bailee, it must address two problems.

First, how does the bailee “issue” this document? Second, can the bailee really be a “bailee” if the parties use the model blockchain? Both problems stem from the decentralized nature of blockchain systems, where there is no single document that is issued in the traditional sense.

While Article 7 of the UCC does not specifically define the term “issue” in the context of a document of title, Article 3 does define the term in the context of the issuance of instruments, such as promissory notes, as “… the first delivery of an instrument to a holder or a remitter”.[12]

“Delivery” is defined in connection with an electronic document of title as “voluntary transfer of control”. Control of an electronic document of title is also specifically defined, and is deemed to exist in favor of a person if “… a system employed for evidencing the transfer of interests in the electronic document reliably establishes that person as the person to which the electronic document was issued or transferred.”[13]

Under the model blockchain, the document of title could be deemed issued when all members of the model blockchain vote to create a blockcoin and assign it to one of the members, which would seem to fit the idea of “delivery” under the UCC.

4. Ensuring the bailee is a bailee

Even if we are comfortable that a blockchain bill of lading might be “issued” within the meaning of the UCC, can we also be comfortable that it was issued by a bailee holding the goods? The UCC defines bailee as “a person that by ... [a] document of title acknowledges possession of goods and contracts to deliver them.”[14]

Presumably, in our model blockchain transactions, the shipper who receives goods from a consignee will be a member of the model blockchain. The shipper/member’s entry of data into the model blockchain to confirm receipt of the goods should suffice as such acknowledgement.

But the UCC definition of “bailee” also requires that the bill of lading be the delivery contract as well as the receipt for the goods. Shipment of the goods under the model blockchain would likely be governed by a smart contract between the shipper/bailee and the holder of the blockcoin.

In a smart contract, the terms of the agreement are incorporated into a computer program that automatically executes the contract’s terms when the correct conditions precedent are met. The code of a smart contract for the carriage of the goods could be stored in the model blockchain and run on the computers of its members, but it would not technically constitute part of the blockchain per se.[15]

Rather, it would run using information that is stored in the blockchain to trigger the conditions for the performance coded into it. In any event, such a contract should permit us to conclude that the shipper would be a “bailee” for UCC purposes.

Since we can posit that the shipper/member of the model blockchain is a person engaged in the business of directly or indirectly transporting or forwarding goods, the above discussion demonstrates that the model blockchain structure — including the bundle comprised of the model blockchain itself, the blockcoin representing the goods and the smart contract encoding the contract of carriage — should constitute a bill of lading under the UCC.

In the second part of this article, we will consider possible ramifications of our model blockchain being covered by the UCC, including whether a blockchain bill of lading could be an electronic document of title, and whether it could be negotiable.

From Bills Of Lading To Blockchain Structures: Part 2

By **Christopher McDermott, Jeffrey Nagle, Martin Horowitz and Stephen Johnson**

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A bill of lading is an old form of legal document. The rules relating to bills of lading and other documents of title evolved over the centuries. Now, technological change — and of particular interest, the emergence of blockchain technology — is raising new questions about the future of this old instrument.

As these blockchain strategies become more accepted in commodities trade, it falls to lawyers to tackle the challenge of fitting the new blockchain structures into the existing legal concepts that evolved for traditional bills of lading. Modern bills of lading still perform the same basic functions as their ancient ancestors: they evidence the title to the goods being shipped, the contract of carriage and the right to receive and direct the disposition of those goods. The blockchain solutions emerging in commodities trading seem to have the same functions.

But do the same legal rules apply? Or put another way, if a blockchain structure acts like a bill of lading, is it a bill of lading under the Uniform Commercial Code? In the first part of this article, we described a model blockchain structure that might fulfill this function, and considered how to ensure its compliance with the requirements of the UCC.

In this installment, we will further explore the ramifications of our model blockchain being covered by the UCC, including whether a blockchain bill of lading could be an electronic document of title, and whether it could be negotiable.

Ramifications of the Model Blockchain Being Covered by the UCC

Could a Blockchain Bill of Lading be an Electronic Document of Title?

Another point to consider — which, as we discuss below, is relevant to the application of other UCC concepts — is whether our model blockchain bill of lading constitutes an "electronic document of title" under the UCC. To be an electronic document of title, a document of title must be (1) evidenced by a record (2) consisting of information stored in an electronic medium.

We already have established that data stored in the model blockchain would constitute a record under the UCC. That record residing on the model blockchain clearly also is stored in an electronic medium. The model blockchain consists of bits of data stored in the distributed ledgers on each of the members' computers, i.e., in an electronic medium. It seems clear, then, that our model blockchain bill of lading would be an electronic document of title.

Could a Blockchain Bill of Lading be "Negotiable"?

As further discussed below, the status of a document of title as negotiable or nonnegotiable has a broad range of effects under the UCC, including effects on rights against issuers and effects on the perfection and priority of security interests. Current legal requirements for making documents of title negotiable have frustrated prior efforts at digitizing bills of lading.[1]

It is therefore relevant to consider whether the model blockchain bill of lading would be negotiable or nonnegotiable under the UCC. We think that the model blockchain bill of lading could be tailored to fit the UCC requirements of a negotiable bill of lading.

Under the UCC, an electronic document of title may be either negotiable or non-negotiable. To be negotiable a document of title must provide "by its terms the goods are to be delivered to bearer or to the order of a named person."[2]

The model blockchain bill of lading would need to satisfy either the "bearer" or "to order" options of this definition. In the permissioned blockchain system we have imagined, the participants must all be members of the system, and information coded into the model blockchain and the related smart contract would need to designate the recipient of the goods by name.

Would it be sufficient for the bill of lading to be "to order" for the model blockchain bill of lading to provide that the member/transferee of the goods may redirect its right to obtain the goods to another member of the model blockchain — or does the exclusion of non-member third parties from the universe of who might obtain the goods under the model blockchain system make it not "to order"?

We think that a model blockchain bill of lading may still be negotiable as being "to order" if it provides for the conversion of the bill of lading from an electronic one resident on the model blockchain (negotiable to members only) to one that may be negotiated to non-members, such as a traditional tangible bill of lading.

The UCC contemplates such conversion. To convert from an electronic to a tangible document of title, the person entitled under the electronic document of title must surrender control of the document of title to the issuer and the issuer must issue a tangible document of title stating "it is issued in substitution for the electronic document."[3] This conversion kills the electronic incarnation of the bill of lading.

While such an escape hatch may be necessary to clearly satisfy the legal definition of a "to order" negotiable document of title, if the model blockchain gained wide enough currency that all or most of the participants in the relevant market were members, then the likelihood of a bill of lading dropping out of the electronic model blockchain system would be diminished.

What about the other leg of negotiability for a bill of lading, providing by its terms for the delivery of the goods "to bearer"? The idea of a bill of lading payable to bearer is clearly a concept deriving from the realm of tangible bills of lading, in which the owners are able to "bear" the tangible document in the sense of physical possession in the real world.

However, electronically stored information, such as the model blockchain bill of lading, cannot be physically "borne" in that traditional sense. And the model blockchain is decentralized, with each member having a copy of the whole blockchain. Facially, the "delivered to bearer" leg of the definition seems not to work for the model blockchain.

The UCC attempts to provide a solution. The term "bearer" is defined to include a person "in control of a negotiable electronic document of title."[4] As discussed above, control of an electronic document of title is satisfied when the electronic system reliably establishes the person to which the document is transferred or issued.

There is, obviously, some circularity in the UCC definitions on this point — in order to determine if the document of title is negotiable, we have to look to a definition of control which is, in turn, defined for electronic documents of title that are negotiable. Nonetheless, it seems that the statutory scheme is

attempting to designate the person reliably established by the electronic system as the holder of the document to be the "bearer" of the document.

So, perhaps, the best way to view the state of the law is that, if control can be established with respect to an electronic document of title, then that electronic document of title should be regarded as negotiable. Our model blockchain bill of lading would seem to be negotiable under this way of thinking as well, even without a tangible bill of lading failsafe.

Negotiation and Due Negotiation

Per our discussion above, the model blockchain bill of lading could be negotiable if properly designed. It could also be non-negotiable. Whether the model blockchain bill of lading is the one variety or the other could have significant effects. The UCC gives different treatment to negotiable and non-negotiable bills of lading, and to holders of negotiable bills of lading to whom the document is transferred by negotiation and "due negotiation".

For example, the ability of a consignee of a non-negotiable bill of lading or the holder of a negotiable bill of lading to recover damages from the issuer of the bill of lading caused by misdating, or by misdescription or nonreceipt of the goods, depends on different factors — giving value in good faith, in the case of the non-negotiable document, and having taken by "due negotiation" in the case of the negotiable one.[5]

Similarly, the lien of a carrier on the goods covered by a bill of lading is subject to limitations, in the case of a purchaser for value of a negotiable bill of lading, that are not otherwise applicable.[6]

One of the most salient impacts is the effect on priority of rights among competing claimants to the document or the goods — whether the competing claimants are direct owners of the bill of lading, or secured parties claiming a security interest in it.[7] Various rules outline the rights of transferees of negotiable and non-negotiable documents of title, and the parties who can defeat the claims of such transferees,[8] in the absence of "due negotiation" of a negotiable bill of lading.

A holder who takes a document of title by due negotiation enjoys a favored position. Such a holder acquires title to the document, title to the goods, all rights under the law of agency or estoppel, including rights to goods delivered to the bailee after the document was issued, and the direct obligation of the issuer to deliver the goods according to the terms of the document free of most defenses or claims by the issuer.

The holder also acquires a title to the goods that is superior to the rights of stoppage of the goods, the rights of a prior holder of the document against which the negotiation was a breach, a person who was done out of the document by fraud and a third party to whom the document or goods were sold.[9] The holder by due negotiation, like a holder in due course of a negotiable instrument, can acquire better title than its transferor.

So what is "due negotiation," and can the holder of a negotiable model blockchain bill of lading obtain that status?

There are two steps. First, a negotiable electronic document of title is "negotiated" when it is "delivered" to another person.[10] Such a document is "delivered" upon a voluntary transfer of control of the document.[11] Control, as previously discussed, can be transferred via entries made in the model

blockchain.

The second step, to establish the “due negotiation” of the negotiable electronic document of title, in general requires the holder to purchase the document in good faith, without notice of any defense against or claim to it on the part of any person, and for value.[12]

It is notable that the second step, to promote the status of a holder to one taking by due negotiation, depends on state of mind factors of the transferee — lack of notice of defenses, and good faith. Further, all negotiations or deliveries of a document of title, even without rising to the level of a due negotiation, trigger certain warranties by the transferor to its immediate transferee that include similar state of mind points: that the transferor does not know of any fact that would impair the document’s validity or worth, and that the negotiation or delivery of the document is rightful and fully effective with respect to the title to the document and the goods it represents.[13]

It is intuitive to understand those state of mind factors in a traditional environment of tangible documents of title, or even a centralized, “trusted” electronic system. But do state of mind factors work in a “trustless,” decentralized blockchain arrangement like our model blockchain, where much of the advantage of the new system is its speed and automation, taking steps in commodity trading transactions out of the hands of human beings?

In one sense, the model blockchain should work with the state of mind factors in “due negotiation” and warranties of transfer in the same way traditional documents of title do, to resolve competing claims in front of a judge.[14] But other complexities might arise. The members of the model blockchain would not be indifferent to their status vis-à-vis competing claimants to the bill of lading and the underlying goods in determining a price they are willing to pay for the bill of lading or ascribing a collateral value or borrowing base eligibility to it for financing purposes.

The model blockchain may, therefore, need to be designed to include protocols permitting members to add additional information to the blockchain as to facts that a member might have or discover regarding specific claims and defenses involving other members or their goods, and that might relate to transactions represented by existing or future model blockchain bills of lading, which would trigger a flag in the smart contract that could prevent the “due negotiation” of a model blockchain bill of lading.

Perhaps the model blockchain would need to impose requirements on the members to input such information promptly, and to embed automatic representations deemed made by members that such information is up-to-date. The model blockchain membership would need to consider the appropriate sanctions for members who fail to add such disclosures to keep the system honest.

Conclusion

The blockchain innovation in commodities trade is already upon us. It appears that, properly designed, a blockchain system can be accommodated in existing UCC provisions governing bills of lading.

Legislators have indicated their willingness to adjust the UCC incrementally to provide for technological developments in electronic commerce that intersect with the existing law. It remains to be seen whether the UCC will change further as more experience accrues with real-life blockchain applications.

Christopher McDermott and Jeffrey Nagle are partners, and Martin Horowitz and Stephen Johnson are associates, in the Charlotte office of Cadwalader Wickersham & Taft LLP. They represent commercial banks and other financial institutions in commercial lending and other financing transactions.

[1] See, e.g., Carriage of Goods by Sea Act of the United States; the Australian Sea-Carriage Documents Bill 1996; and the Carriage of Goods by Sea Act of 1992 (UK); the International Convention for the Unification of Certain Rules relating to Bills of Lading at Brussels of Aug. 25, 1924.

[2] Unless otherwise noted, references to the UCC used in this article will be to the Uniform Commercial Code as in effect in New York.

[3] See, e.g., "What's cooking in the blockchain kitchen?" (2017), https://www.ing.com/Newsroom/All-news/Whats-cooking-in-the-blockchain-kitchen.htm; and Denis Balibouse, Mercuria Introduces Blockchain to Oil Trade with ING, SocGen, Reuters, Jan. 19, 2017, http://www.reuters.com/article/us-davos-meeting-mercuria-idUSKBN1531DJ.

[4] See generally Satoshi Nakamoto, Bitcoin: A Peer-to-Peer Electronic Cash System, https://bitcoin.org/bitcoin.pdf (outlining the framework of Bitcoin); and White Paper: A Next-Generation Smart Contract and Decentralized Application Platform, https://github.com/ethereum/wiki/wiki/White-Paper (outlining the framework of Ethereum).

[5] For examples of recent endeavors, see Blockchain: A Better Way to Track Pork Chops, Bonds, Bad Peanut Butter?, N.Y. Times, https://www.nytimes.com/2017/03/04/business/dealbook/blockchain-ibm-bitcoin.html.

[6] Bitcoins used for such purposes are called "colored coins." Nicolas Dorier, Programming The Blockchain in C# 95, https://www.gitbook.com/download/pdf/book/programmingblockchain/programmingblockchain.

[7] UCC 1-201(6).

[8] UCC 1-201(16).

[9] UCC 1-201(31).

[10] See, e.g., Bank of New York v. Amoco Oil Co., 35 F.3d 643, 651 (C.A.2 (N.Y.), 1994).

[11] See Report on Revised Article 7 of the Uniform Commercial Code, New York City Bar, http://www2.nycbar.org/pdf/report/uploads/20072201-ReportonRevisedArticle7oftheUniformCommercialCode.pdf. "The concept of an electronic document of title itself allows for commercial practice to determine what records issued by bailees are 'in the regular course of business or financing' and are 'treated as adequately evidencing that the person in possession or control of the record is entitled to receive, control, hold, and dispose of the record and the goods the record covers'." Id. at 3.

[12] UCC 3-102(1)(a).

[13] UCC 7-106(a).

[14] UCC 7-102(a)(1).

[15] In Ethereum, for instance, the smart contract code is written into the transaction data so that it cannot be changed and is run on the appropriate member's computer system. So a copy of the code is a part of that blockchain, but the software is not run "on" the blockchain network.

[1] For instance SEADOCS — where a centralized third-party custodian held all paper bills of lading and acted as the registry — failed after less than a year of operations, and Project BOLERO — an electronic document exchange with a centralized third party acting as the registry — has failed to gain much traction even after more than a decade of operations. See Susan Beecher, Can the Electronic Bill of Lading Go Paperless?, 40 Int'l Law. 627 636-637 (2006).

[2] UCC 7-104.

[3] UCC 7-105(a).

[4] UCC 1-201(5).

[5] UCC 7-301(a).

[6] UCC 7-307(a).

[7] The priority rules set out in Article 9 preserve in an Article 9 security interest scheme the priorities established in Article 7 with respect to the rights of a holder of a negotiable document of title to which the document has been duly negotiated. See UCC 9-331(a).

[8] See UCC 7-504.

[9] UCC 7-502.

[10] UCC 7-501(b)(1).

[11] UCC 1-201(15).

[12] UCC 7-501(b)(3). Note that "purchase" as used in this provision has a broad meaning, encompassing the grant of liens and security interests as well as absolute transfers. UCC 1-201(29).

[13] UCC 7-507.

[14] Indeed, the concept of documents of title as "magic" pieces of paper that might be transferred from hand to hand in the stream of commerce far away from the original issuer is already "chained," and rather more analogous to blockchain systems, than other "hub and spoke" structures which are exploring utility of blockchain, such securities intermediary arrangements in brokerage accounts.

NAV and Hybrid Loan Facilities: Current Issues and Trends

Brian Foster

CADWALADER FINANCE FORUM

NAV/HYBRID FACILITIES PANEL

November 2017

Cadwalader, Wickersham & Taft LLP
www.cadwalader.com

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NAV FACILITIES

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COLLATERAL STRUCTURES

- Pledge of equity interests in SPV that owns private funds
- Pledge of equity interests in borrower and borrower GP
- Direct pledge of investments in private funds
- Pledge of securities account
- Guarantor arrangements and other credit enhancements

UNDERWRITING/VALUATION OF UNDERLYING INVESTMENT PORTFOLIOS

- Top down vs. bottom up approach
- Availability/frequency of third party valuations
- Differing valuation methodologies
- Transparency to ultimate assets of third party funds
- Due Diligence

ADDRESSING UNFUNDED COMMITMENTS TO UNDERLYING INVESTMENT PORTFOLIO

- Uncalled capital from upstream investors
- Unused capacity under credit facility
- Anticipated distributions from underlying investment portfolio

DOCUMENTARY DUE DILIGENCE ISSUES

- Scope of lien restrictions
- Consent requirements
- Liquidity Constraints
- Potential Impairment of Value
- Reliance on Borrower Due Diligence

CURRENT TRENDS IN NAV FACILITIES

- Mixed collateral pools
- Multi-jurisdictional complexities
- Collateral conversion transactions

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HYBRID FACILITIES

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HYBRID FACILITIES

- What is a hybrid facility
- Uses of hybrid facilities

HYBRID FACILITIES: BORROWERS

- Borrowers best suited for hybrid facilities
- Borrower challenges in structuring/executing hybrid facilities

HYBRID FACILITIES: CONSIDERATIONS

- Lender challenges in structuring/executing hybrid facilities
- Upsides/downsides of NAV facilities vs. pure subscription on hybrid facilities
- Market trends for hybrid facilities

Notice and Disclaimer

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Commercial Real Estate CLOs: The Year in Review

Stuart Goldstein

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Presentation on CRE CLOs

Creditflux CLO Investor Summit
October 25, 2017

What Are CRE CLOs?

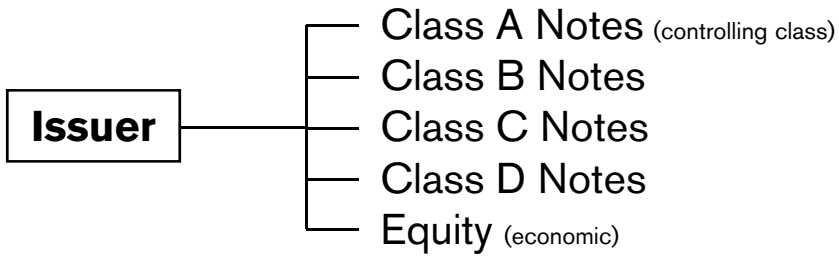
- CRE CLOs are a repackaging of commercial Mortgage Loans, B Notes, Junior Participations and Mezzanine Loans

- The resulting securities are multiclass, with highly-rated senior tranches and non-rated junior and equity tranches

CLO vs. CMBS

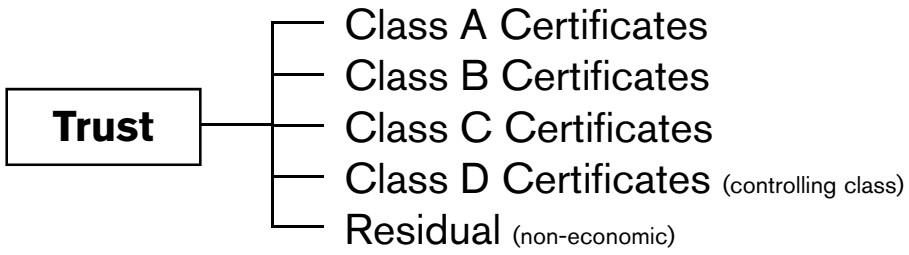
CLO

- Any loan
- Can have ramp-up period; reinvestment of principal periods; allowed to trade collateral
- Structured as "corporate notes" – obligations of the issuer
- If Issuer is offshore (and not a QRS), Issuer will be subject to tax "guidelines"



CMBS (REMIC)

- Assets need to be "qualified" mortgage loans for REMIC purposes
- Static pool
- Structured as "pass-through" interests in a common law trust



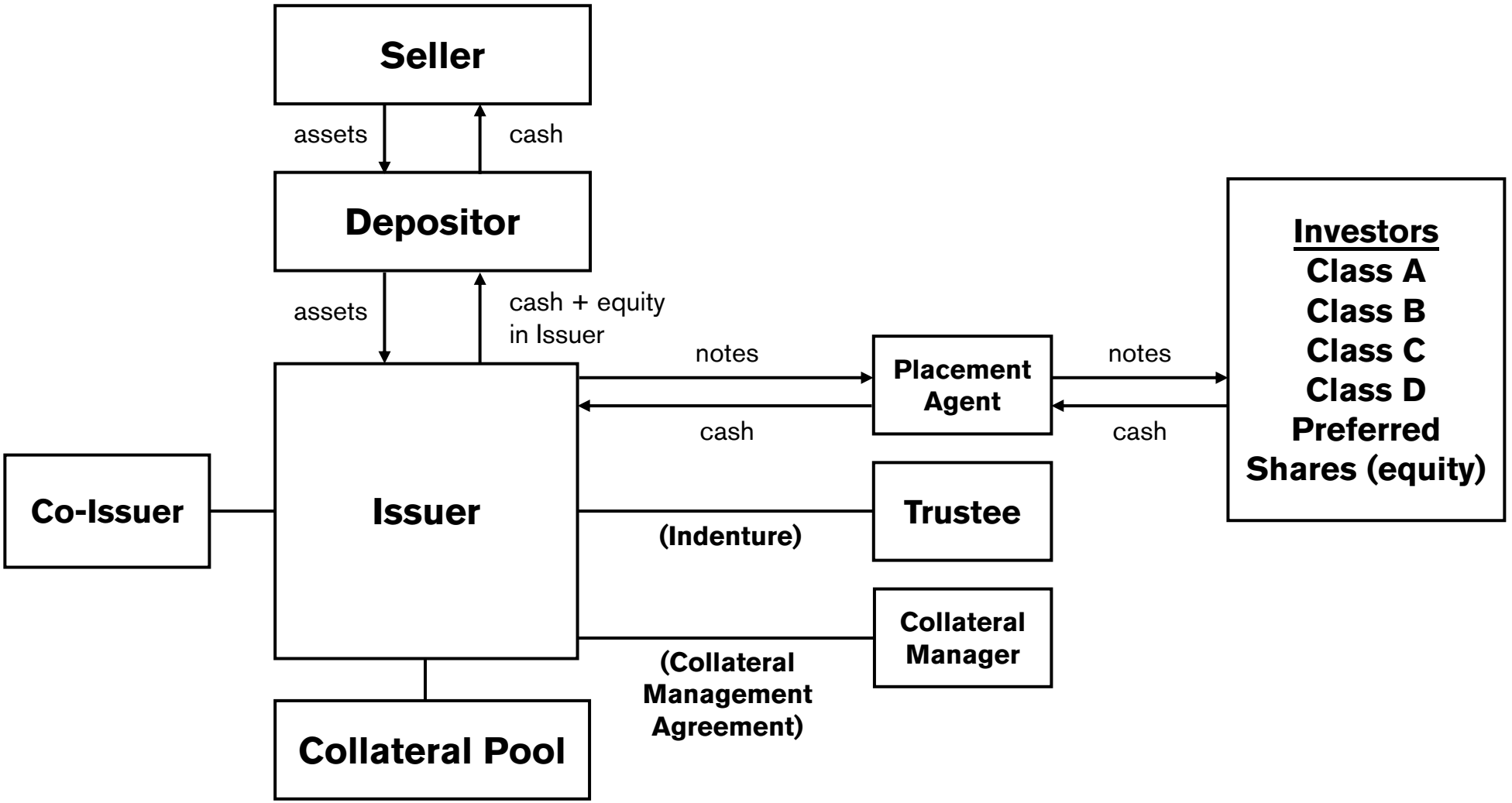
Issuer Motivations

- Balance Sheet CLOs
  - Secure long-term financing at better terms than warehouse lines of credit
  - Match term of financing to maturities of the underlying assets
- Arbitrage CLOs
  - Arbitrage investment vehicle for the sponsor/equity holders
  - Generate advisory fees for the collateral manager
  - Increase assets under management

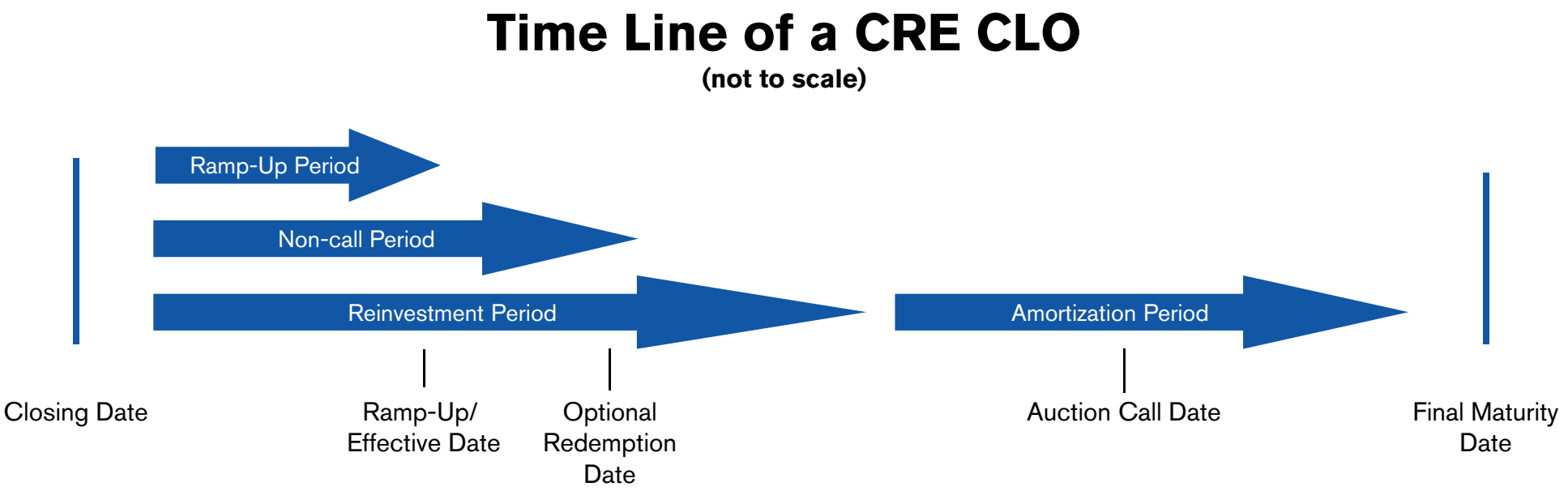
CRE CLO 2.0 Structural Features

- More extensive asset-level disclosure
- Disclosure on ramp-up assets that are in the pipe-line
- No discretionary sales – sales limited to defaulted assets and credit risk assets
- Limited reinvestment

Generic CRE CLO Structure



Basic Structure/Components



- Ramp-Up Period
  - Period during which the collateral manager needs to identify and acquire additional collateral with the cash reserved at closing
- Reinvestment Period
  - Period during which collateral manager can reinvest principal proceeds into new collateral
  - Purpose is to reinvest principal on shorter term underlying assets to maximize the efficiency of the funding

Coverage, Quality & Diversity Tests

- Coverage Tests:
- Overcollateralization (Par Value) Tests
  - Used on a monthly basis to test levels of credit support. Compares balance of assets to liabilities
  - Haircuts applied to defaulted assets (typically lower of fair market value and recovery rate)
- Interest Coverage Tests
  - Used on a monthly basis to test levels of interest coverage. Compares interest due from assets to interest owed on liabilities
- Consequence of Failure: Mandatory Redemption
  - Use interest proceeds to redeem principal until coverage tests are satisfied. If interest proceeds are insufficient, principal proceeds that would have otherwise been reinvested are used to redeem the notes until the coverage tests are satisfied

Coverage, Quality & Diversity Tests (CONT'D)

- Collateral Quality Tests:
- In order to ensure the quality and diversity of the asset pool, various tests can be implemented to measure the following characteristics of individual assets and the collateral pool:
  - Minimum Coupon and Weighted Average Coupon
  - Maximum Maturity and Weighted Average Life
  - Weighted Average Rating Factor ("WARF") (measures overall credit quality)
  - Weighted Average Recovery Rate
  - Loan-to-Value Ratio
  - Debt Service Coverage
  - Debt Yield

Coverage, Quality & Diversity Tests (CONT'D)

Additional Reinvestment Criteria:

- Portfolio percentage limitations on:
  - property type concentration
  - geographic concentration
  - collateral type concentration (*i.e.*, loans, mezzanine, CMBS, etc.)
  - affiliated issuer/obligor concentration
  - fixed or floating rate assets
- Asset is not impaired or credit risk
- Outside maturity date
- Appropriate servicing is in place
- Appropriate representations and warranties are delivered

Consequence of failure: Cannot acquire assets in Ramp-up or Reinvestment Period if test will fail after giving effect to their acquisition. Transactions generally allow acquisition of collateral as long as quality tests/reinvestment criteria will not get worse as a result of the acquisition

Rating Agency Requirements for Collateral

- Servicing – CMBS style servicing agreements with servicing standard overrides by master servicer and special servicer

- Representations and Warranties – Representations and warranties similar to those given in CMBS transactions, including repurchase remedy for breach. This applies to both initial collateral assets as well as future acquired assets

- Advancing – "Advancing Agent" is responsible for advancing interest to ensure timely payment of interest on most senior classes of Notes

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FINANCE FORUM

Recent Litigation and Enforcement Trends in the Financial Sector

Joseph Moreno

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Cadwalader, Wickersham & Taft LLP
www.cadwalader.com

Litigation and Enforcement Trends in the Financial Sector

November 8, 2017

PANELISTS

Moderator

Anne Tompkins
Partner, White Collar Defense and Investigations
Cadwalader, Wickersham & Taft LLP
Charlotte

Jason Halper
Practice Chair, Global Litigation
Cadwalader, Wickersham & Taft LLP
New York

Maureen Dollinger O'Connor
Vice President, Financial Crime Legal, Americas
Barclays Capital Inc.
Washington, DC

Joseph Moreno
Partner, White Collar Defense and Investigations
Cadwalader, Wickersham & Taft LLP
Washington, DC

AGENDA

- AML/BSA, Terrorist Financing, and Economic Sanctions
  - Continued focus by regulators on financial crimes, and new sanctions against Russia, Iran, North Korea, and Venezuela
- DOJ Enforcement and Compliance
  - New compliance guidance is issued, the first Compliance Consultant resigns, and corporate prosecutions continue
- Cybersecurity and Data Protection
  - Equifax breach provides lessons learned, and NY DFS issues first state cybersecurity rules
- Other Regulatory Activity and Private Litigation
  - Financial Crisis fallout is still felt, SEC focuses on retail investors and ICOs, and banks face constantly higher litigation threat
- Issues and Priorities for 2018

AML/BSA, Terrorist Financing, and Economic Sanctions

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AML/BSA, TERRORIST FINANCING AND ECONOMIC SANCTIONS

- 2017 has demonstrated a continued focus by federal, state, and international regulators on financial crimes
  - FinCEN expanded its use of Geographic Targeting Orders (GTOs) in high-end residential real estate markets
  - SEC and FINRA continued focus on AML program deficiencies as broker-dealer examination priorities
  - NY DFS rules requiring certification of compliance with AML transaction monitoring went into effect
- Similar emphasis in UK, where laws provided for new offense of failure to prevent tax evasion, execution of Unexplained Wealth Orders, and expanded use of DPAs

AML/BSA, TERRORIST FINANCING AND ECONOMIC SANCTIONS

- Significant focus on preparing for FinCEN's upcoming Customer Due Diligence (CDD) rules
  - Require covered financial institutions (banks, broker-dealers, mutual funds, FCMs, and commodities introducing brokers) to identify beneficial owners behind legal entities (corporations, partnerships, LLCs) opening new accounts
  - Beneficial ownership defined as natural persons who own ≥ 25% and one person who has control of the legal entity
  - Impose risk-based procedures to identify customer risk and conduct ongoing monitoring to identify suspicious transactions
  - Full compliance required by May 2018

AML/BSA, TERRORIST FINANCING AND ECONOMIC SANCTIONS

OFAC

- On August 2, 2017, President Trump signed the Countering America's Adversaries Through Sanctions Act (CAATSA) which expanded several sanctions programs:

Russia: Discretionary and mandatory sanctions against Russia's financial, energy, defense, mining and transport sectors

Iran: Codifies certain non-nuclear related sanctions against Iran and Iranian parties, including the Islamic Revolutionary Guard Corps and others involved with Iran's military sector, or ballistic missiles or WMD programs, and those involved in Iranian human rights abuses

North Korea: Expansion of discretionary and mandatory sanctions

AML/BSA, TERRORIST FINANCING AND ECONOMIC SANCTIONS

OFAC

- In August 2017, OFAC blocked dealings with certain government officials of Venezuela, and shortly after President Trump signed EO 13808, banning transactions related to:
  - New debt with a maturity of > 90 days of Petróleos de Venezuela, S.A. (PdVSA) (Venezuela's state-owned oil and natural gas company)
  - New debt with a maturity of > 30 days, or new equity, of the Government of Venezuela
  - Bonds issued by the Government of Venezuela before the effective date of the Executive Order (General License 3 exception)
  - Dividend payments or other distributions of profits to the Government of Venezuela from any entity owned or controlled, directly or indirectly, by the Government of Venezuela
  - Purchasing securities, directly or indirectly, from the Government of Venezuela, other than new debt with a maturity of ≤ 90 days (for PdVSA) or ≤ 30 days (for other Government of Venezuela debt)

DOJ Enforcement and Compliance

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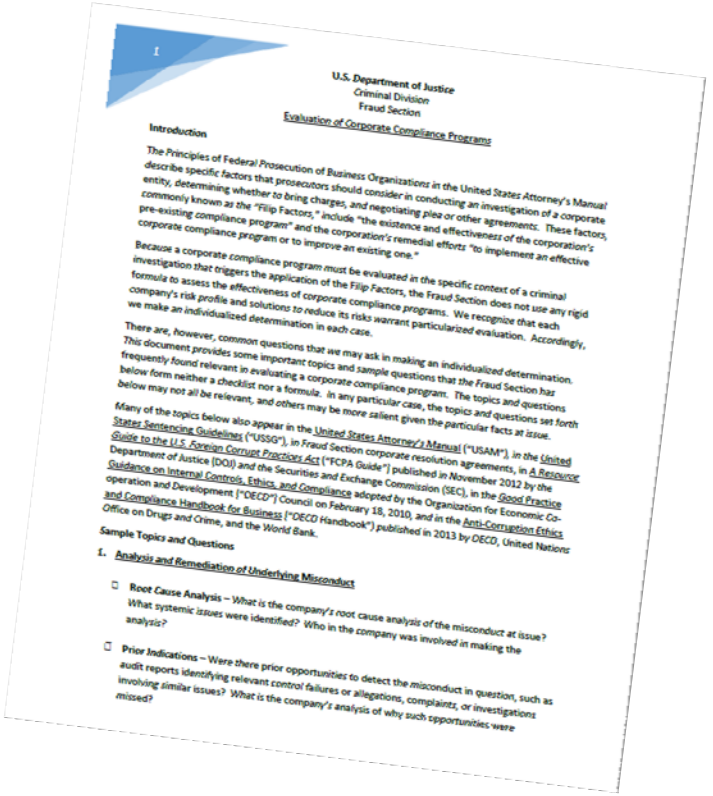
DOJ ENFORCEMENT AND COMPLIANCE

- Compliance Guidance: In February 2017, the Fraud Section released guidance on "Evaluation of Corporate Compliance Programs" to assess compliance programs
  - A blueprint of "important topics" that calls for "root cause" analysis of misconduct
  - Looks for buy-in from senior management
  - Expects to see avenues for internal reporting and whistleblower protection
  - Followed shortly by Hui Chen's early departure from the DOJ



U.S. Department of Justice
Criminal Division
Fraud Section

Evaluation of Corporate Compliance Programs

Introduction

The Principles of Federal Prosecution of Business Organizations in the United States Attorney's Manual describe specific factors that prosecutors should consider in conducting an investigation of a corporate entity, determining whether to bring charges, and negotiating plea or other agreements. These factors, commonly known as the "Filip Factors," include "the existence and effectiveness of the corporation's pre-existing compliance program" and the corporation's remedial efforts "to implement an effective corporate compliance program or to improve an existing one."

Because a corporate compliance program must be evaluated in the specific context of a criminal investigation that triggers the application of the Filip Factors, the Fraud Section does not use any rigid formula to assess the effectiveness of corporate compliance programs. We recognize that each company's risk profile and solutions to reduce its risks warrant particularized evaluation. Accordingly, we make an individualized determination in each case.

There are, however, common questions that we may ask in making an individualized determination. This document provides some important topics and sample questions that the Fraud Section has frequently found relevant in evaluating a corporate compliance program. The topics and questions below form neither a checklist nor a formula. In any particular case, the topics and questions set forth below may not all be relevant, and others may be more salient given the particular facts at issue.

Many of the topics below also appear in the United States Attorney's Manual ("USAM"), in the United States Sentencing Guidelines ("USSG"), in Fraud Section corporate resolution agreements, in A Resource Guide to the U.S. Foreign Corrupt Practices Act ("FCPA Guide") published in November 2012 by the Department of Justice (DOJ) and the Securities and Exchange Commission (SEC), in the Good Practice Guidance on Internal Controls, Ethics, and Compliance adopted by the Organization for Economic Co-operation and Development ("OECD") Council on February 18, 2010, and in the Anti-Corruption Ethics and Compliance Handbook for Business ("OECD Handbook") published in 2013 by OECD, United Nations Office on Drugs and Crime, and the World Bank.

Sample Topics and Questions

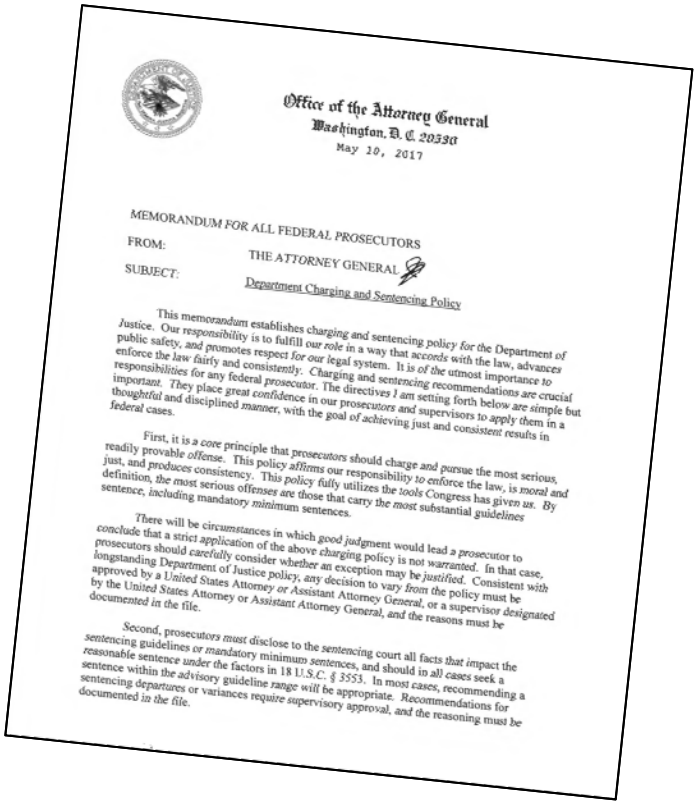
1. Analysis and Remediation of Underlying Misconduct

- Root Cause Analysis – What is the company's root cause analysis of the misconduct at issue? What systemic issues were identified? Who in the company was involved in making the analysis?
- Prior Indications – Were there prior opportunities to detect the misconduct in question, such as audit reports identifying relevant control failures or allegations, complaints, or investigations involving similar issues? What is the company's analysis of why such opportunities were missed?

DOJ ENFORCEMENT AND COMPLIANCE

- Charging Guidance: In May 2017, AG Sessions issued guidance to federal prosecutors instructing them to pursue the most severe penalties, including mandatory minimum sentences

"It is a core principle that prosecutors should charge and pursue the most serious, readily provable offense"



Office of the Attorney General
Washington, D. C. 20530
May 10, 2017

MEMORANDUM FOR ALL FEDERAL PROSECUTORS

FROM: THE ATTORNEY GENERAL

SUBJECT: Department Charging and Sentencing Policy

This memorandum establishes charging and sentencing policy for the Department of Justice. Our responsibility is to fulfill our role in a way that accords with the law, advances public safety, and promotes respect for our legal system. It is of the utmost importance to enforce the law fairly and consistently. Charging and sentencing recommendations are crucial responsibilities for any federal prosecutor. The directives I am setting forth below are simple but important. They place great confidence in our prosecutors and supervisors to apply them in a thoughtful and disciplined manner, with the goal of achieving just and consistent results in federal cases.

First, it is a core principle that prosecutors should charge and pursue the most serious, readily provable offense. This policy affirms our responsibility to enforce the law, is moral and just, and produces consistency. This policy fully utilizes the tools Congress has given us. By definition, the most serious offenses are those that carry the most substantial guidelines sentence, including mandatory minimum sentences.

There will be circumstances in which good judgment would lead a prosecutor to conclude that a strict application of the above charging policy is not warranted. In that case, prosecutors should carefully consider whether an exception may be justified. Consistent with longstanding Department of Justice policy, any decision to vary from the policy must be approved by a United States Attorney or Assistant Attorney General, or a supervisor designated by the United States Attorney or Assistant Attorney General, and the reasons must be documented in the file.

Second, prosecutors must disclose to the sentencing court all facts that impact the sentencing guidelines or mandatory minimum sentences, and should in all cases seek a reasonable sentence under the factors in 18 U.S.C. § 3553. In most cases, recommending a sentence within the advisory guideline range will be appropriate. Recommendations for sentencing departures or variances require supervisory approval, and the reasoning must be documented in the file.

DOJ ENFORCEMENT AND COMPLIANCE

- Despite initial questions about the DOJ's priorities under President Trump, few significant changes have resulted
  - In March 2017, the FCPA Pilot Program was extended
  - The Individual Accountability Policy (a/k/a "Yates Memo") remains in effect, and DAG Rosenstein recently emphasized the importance of prosecuting individuals
  - DOJ has continued prosecuting bribery and financial crimes; however, many were initiated under the Obama Administration and it is unclear whether trend will continue

"Federal prosecutors should be cautious about closing investigations in return for corporate payments, without pursuing individuals who broke the law."

Deputy Attorney General Rod Rosenstein (October 2017)

Cybersecurity and Data Protection

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EQUIFAX BREACH KEEPS CYBER IN THE HEADLINES

- Equifax breach provides lessons learned, and shows wide range of regulators who have a hand in cyber enforcement


REUTERS

#CYBER RISK

OCTOBER 2, 2017 / 10:52 AM / 21 DAYS AGO

Equifax failed to patch security vulnerability in March: former CEO

FTC: Enforces FTC Act Section 5 (unfair and deceptive practices) and the GLB's Safeguards Rule

SEC: Enforces Regulation S-P (for financial institutions) and disclosure obligations for public companies

DOJ: Looking at potential insider trading committed by senior Equifax executives

State Attorneys General: Mass. suing for failure to protect personal information of 3 million state residents

STATES GET INTO THE CYBER BUSINESS

- Compliance with NY DFS "first-in-the-nation" cybersecurity rules became mandatory in phases starting August 28, 2017

1st Deadline — **August 28, 2017**

- Adopt written cybersecurity policies and procedures, including an incident response plan.
- Designate a Chief Information Security Officer (CISO) and retain qualified cybersecurity personnel.
- Notify DFS within 72 hours of determining that a cybersecurity event has occurred.
- Ensure that only appropriate personnel may access confidential non public data.

2nd Deadline — **February 15, 2018**

- Submit annual compliance certifications, signed by a senior officer, to DFS.

3rd Deadline — **March 1, 2018**

- Implement multi-factor authentication.
- Conduct regular penetration testing and risk assessments.
- Implement cybersecurity awareness training.

4th Deadline — **September 1, 2018**

- Encrypt confidential data
- Monitor user activity.
- Implement secure data disposal procedures.
- Maintain audit trails for network activity and significant transactions.

Final Deadline

March 1, 2019

Adopt comprehensive cybersecurity risk management programs for third party service providers.

STATES GET INTO THE CYBER BUSINESS

- Apply to "Covered Entities" – any entity that is licensed to do business in New York by the DFS
  - Banks that receive a charter from the DFS
  - Branches, representative offices, agencies, and investment companies of foreign banks
  - Money services and virtual currency businesses
  - Insurance companies
  - Mortgage brokers
  - *DFS has proposed applying the rules to credit reporting agencies*
- Although not expressly subject to the rules, the rules will affect any third-party vendor that has access to a Covered Entity's computer network or confidential data

CONSTANT DEVELOPMENTS IN DATA PROTECTION LAWS

- Financial institutions continue to be subject to a growing number of state, federal, and international data protection regulations, which require:
  - Reasonable measures to protect data and systems
  - Written policies and procedures
  - Active management of third-party cybersecurity risk
  - Senior management/board involvement
  - Potential fines and penalties for non-compliance
- Bottom line: Firms should view cybersecurity compliance as they do more traditional compliance programs, such as those addressing financial crime risk

Other Regulatory Activity and Private Litigation

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OTHER REGULATORY ACTIVITY AND PRIVATE LITIGATION

STOPFRAUD.GOV
FINANCIAL FRAUD ENFORCEMENT TASK FORCE

- **RMBS Working Group**, formed in 2009 and consisting of DOJ, SEC, NYAG, and other agencies, continues to investigate fraud and abuse regarding the 2008 Financial Crisis
  - In January 2017, DOJ reached multi-billion dollar settlements with several Swiss banks to settle claims of misleading investors of RMBS, and with Moody's regarding its role in providing credit ratings for RMBS and CDOs
  - In September 2017, DOJ filed a civil complaint against DB's former head of subprime trading for misleading investors about quality of loans backing a 2007 securitization

OTHER REGULATORY ACTIVITY AND PRIVATE LITIGATION

- In addition to Cyber, the SEC's other stated priority is the protection of retail investors (Stephanie Avakian, SEC Co-Director of Enforcement, October 2017)
  - Retail Strategy Task Force will focus on issues that impact retail investors
  - Initial actions brought have included unauthorized access to investor accounts, charging customers excessive fees, and failing to ensure adequate procedures to provide customers' information on lowest price fund shares
  - Avakian claims this new priority will not detract from financial fraud and insider trading cases

OTHER REGULATORY ACTIVITY AND PRIVATE LITIGATION

- In September 2017, the SEC brought enforcement actions against two so-called Initial Coin Offerings (ICOs)
- The actions followed an earlier investigation of "The DAO" in summer 2017, in which the SEC found that digital tokens constitute "securities" under the securities laws
- The CFTC also brought its fourth enforcement action in this space in 2017, asserting that Bitcoin and other digital currencies are "commodities" under the Commodity Exchange Act

OTHER REGULATORY ACTIVITY AND PRIVATE LITIGATION

- Aggressive plaintiff's counsel continue to seek clients to pursue actions against financial institutions stemming from the Financial Crisis, including:
  - Federal and state fraud actions against issuers and collateral managers seeking rescission or damages for losses from pools of mortgage loans underlying RMBS
  - Continued use of the Anti-Terrorism Act (ATA), which provides a private right of action and treble damages for victims of international terrorism, and has been used against banks, oil companies, logistics companies, and pharmaceuticals
- Spike in litigation also potentially attributable to whistleblower bounty program established by Dodd-Frank

Issues and Priorities for 2018

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ISSUES AND PRIORITIES FOR 2018

- Continued use of sanctions as a foreign policy tool by the Trump Administration, and additional implementation of discretionary sanctions set out in CAATSA
- FinCEN Customer Due Diligence (CDD) Rules go into effect in May 2018
- EU General Data Protection Regulation (GDPR) becomes effective in May 2018
- Phased implementation of NY DFS Cybersecurity Rules continue through March 2019

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Belgium: Legal Notice under Article 7 of Belgian Law of March 11, 2003: The Belgian lawyers practicing in the Brussels office are admitted to practice under the professional title "advocaat/avocat." They are members of the Brussels Bar, List A. The lawyers from other foreign jurisdictions are members of, or are registered with, the Brussels Bar, List E or B, and/or are members of foreign Bars. Each lawyer's bar admission(s) can be found in his/her biography. Members of the Brussels Bar (List A, B or E) are subject to professional rules that are available at www.baliebrussel.be or www.barreauderbruxelles.be. The profession of "avocat/advocaat" is regulated by Articles 428-508 of the Belgian Judicial Code, which is available at www.juridat.be.

Beijing: Pursuant to the rules and regulations of the People's Republic of China (PRC), Cadwalader, as an international law firm, is not permitted to practice PRC law in its Beijing office. We provide advice to our U.S. clients based on our prior experience in cross-border China-related transactions and our understanding of the PRC legal environment and, where appropriate, we engage registered PRC law firms with qualified PRC lawyers to work alongside our legal professionals. Cadwalader provides legal advice to its PRC clients on U.S. matters with the support of our U.S. lawyers.

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Any inconsistent previous policy of the Department of Justice relating to these matters is rescinded, effective today.[1]

Each United States Attorney and Assistant Attorney General is responsible for ensuring that this policy is followed, and that any deviations from the core principle are justified by unusual facts.

I have directed the Deputy Attorney General to oversee implementation of this policy and to issue any clarification and guidance he deems appropriate for its just and consistent application.

Working with integrity and professionalism, attorneys who implement this policy will meet the high standards required of the Department of Justice for charging and sentencing.

[1] Previous policies include: *Department Policy on Charging Mandatory Minimum Sentences and Recidivist Enhancements in Certain Drug Cases* (August 12, 2013); and *Guidance Regarding § 851 Enhancements in Plea Negotiations* (September 24, 2014).

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Because a corporate compliance program must be evaluated in the specific context of a criminal investigation that triggers the application of the Filip Factors, the Fraud Section does not use any rigid formula to assess the effectiveness of corporate compliance programs. We recognize that each company's risk profile and solutions to reduce its risks warrant particularized evaluation. Accordingly, we make an individualized determination in each case.

There are, however, common questions that we may ask in making an individualized determination. This document provides some important topics and sample questions that the Fraud Section has frequently found relevant in evaluating a corporate compliance program. The topics and questions below form neither a checklist nor a formula. In any particular case, the topics and questions set forth below may not all be relevant, and others may be more salient given the particular facts at issue.

Many of the topics below also appear in the United States Attorney's Manual ("USAM"), in the United States Sentencing Guidelines ("USSG"), in Fraud Section corporate resolution agreements, in *A Resource Guide to the U.S. Foreign Corrupt Practices Act* ("FCPA Guide") published in November 2012 by the Department of Justice (DOJ) and the Securities and Exchange Commission (SEC), in the Good Practice Guidance on Internal Controls, Ethics, and Compliance adopted by the Organization for Economic Co-operation and Development ("OECD") Council on February 18, 2010, and in the Anti-Corruption Ethics and Compliance Handbook for Business ("OECD Handbook") published in 2013 by OECD, United Nations Office on Drugs and Crime, and the World Bank.

Sample Topics and Questions

1. Analysis and Remediation of Underlying Misconduct

- **Root Cause Analysis** – What is the company's root cause analysis of the misconduct at issue? What systemic issues were identified? Who in the company was involved in making the analysis?

- **Prior Indications** – Were there prior opportunities to detect the misconduct in question, such as audit reports identifying relevant control failures or allegations, complaints, or investigations involving similar issues? What is the company's analysis of why such opportunities were missed?

- **Remediation** – What specific changes has the company made to reduce the risk that the same or similar issues will not occur in the future? What specific remediation has addressed the issues identified in the root cause and missed opportunity analysis?

2. Senior and Middle Management[1]

- **Conduct at the Top** – How have senior leaders, through their words and actions, encouraged or discouraged the type of misconduct in question? What concrete actions have they taken to demonstrate leadership in the company's compliance and remediation efforts? How does the company monitor its senior leadership's behavior? How has senior leadership modelled proper behavior to subordinates?

- **Shared Commitment** – What specific actions have senior leaders and other stakeholders (*e.g.*, business and operational managers, Finance, Procurement, Legal, Human Resources) taken to demonstrate their commitment to compliance, including their remediation efforts? How is information shared among different components of the company?

- **Oversight** – What compliance expertise has been available on the board of directors? Have the board of directors and/or external auditors held executive or private sessions with the compliance and control functions? What types of information have the board of directors and senior management examined in their exercise of oversight in the area in which the misconduct occurred?

3. Autonomy and Resources[2]

- **Compliance Role** – Was compliance involved in training and decisions relevant to the misconduct? Did the compliance or relevant control functions (*e.g.*, Legal, Finance, or Audit) ever raise a concern in the area where the misconduct occurred?

- **Stature** – How has the compliance function compared with other strategic functions in the company in terms of stature, compensation levels, rank/title, reporting line, resources, and access to key decision-makers? What has been the turnover rate for compliance and relevant control function personnel? What role has compliance played in the company's strategic and operational decisions?

- **Experience and Qualifications** – Have the compliance and control personnel had the appropriate experience and qualifications for their roles and responsibilities?

- **Autonomy** – Have the compliance and relevant control functions had direct reporting lines to anyone on the board of directors? How often do they meet with the board of directors? Are members of the senior management present for these meetings? Who reviewed the performance of the compliance function and what was the review process? Who has determined compensation/bonuses/raises/hiring/termination of compliance officers? Do the compliance and relevant control personnel in the field have reporting lines to headquarters? If not, how has the company ensured their independence?

- **Empowerment** – Have there been specific instances where compliance raised concerns or objections in the area in which the wrongdoing occurred? How has the company responded to such compliance concerns? Have there been specific transactions or deals that were stopped, modified, or more closely examined as a result of compliance concerns?

- **Funding and Resources** – How have decisions been made about the allocation of personnel and resources for the compliance and relevant control functions in light of the company's risk profile? Have there been times when requests for resources by the compliance and relevant control functions have been denied? If so, how have those decisions been made?

- **Outsourced Compliance Functions** – Has the company outsourced all or parts of its compliance functions to an external firm or consultant? What has been the rationale for doing so? Who has been involved in the decision to outsource? How has that process been managed (including who oversaw and/or liaised with the external firm/consultant)? What access level does the external firm or consultant have to company information? How has the effectiveness of the outsourced process been assessed?

4. Policies and Procedures[3]

a. Design and Accessibility

- **Designing Compliance Policies and Procedures** – What has been the company's process for designing and implementing new policies and procedures? Who has been involved in the design of policies and procedures? Have business units/divisions been consulted prior to rolling them out?

- **Applicable Policies and Procedures** – Has the company had policies and procedures that prohibited the misconduct? How has the company assessed whether these policies and procedures have been effectively implemented? How have the functions that had ownership of these policies and procedures been held accountable for supervisory oversight?

- **Gatekeepers** – Has there been clear guidance and/or training for the key gatekeepers (*e.g.*, the persons who issue payments or review approvals) in the control processes relevant to the misconduct? What has been the process for them to raise concerns?

- **Accessibility** – How has the company communicated the policies and procedures relevant to the misconduct to relevant employees and third parties? How has the company evaluated the usefulness of these policies and procedures?

b. **Operational Integration**

- **Responsibility for Integration** – Who has been responsible for integrating policies and procedures? With whom have they consulted (*e.g.*, officers, business segments)? How have they been rolled out (*e.g.*, do compliance personnel assess whether employees understand the policies)?

- **Controls** – What controls failed or were absent that would have detected or prevented the misconduct? Are they there now?

- **Payment Systems** – How was the misconduct in question funded (*e.g.*, purchase orders, employee reimbursements, discounts, petty cash)? What processes could have prevented or detected improper access to these funds? Have those processes been improved?

- **Approval/Certification Process** – How have those with approval authority or certification responsibilities in the processes relevant to the misconduct known what to look for, and when and how to escalate concerns? What steps have been taken to remedy any failures identified in this process?

- **Vendor Management** – If vendors had been involved in the misconduct, what was the process for vendor selection and did the vendor in question go through that process? See further questions below under Item 10, "Third Party Management."

5. Risk Assessment[4]

- **Risk Management Process** – What methodology has the company used to identify, analyze, and address the particular risks it faced?

- **Information Gathering and Analysis** – What information or metrics has the company collected and used to help detect the type of misconduct in question? How has the information or metrics informed the company's compliance program?

- **Manifested Risks** – How has the company's risk assessment process accounted for manifested risks?

6. Training and Communications[5]

- **Risk-Based Training** – What training have employees in relevant control functions received? Has the company provided tailored training for high-risk and control employees that addressed the risks in the area where the misconduct occurred? What analysis has the company undertaken to determine who should be trained and on what subjects?

- **Form/Content/Effectiveness of Training** – Has the training been offered in the form and language appropriate for the intended audience? How has the company measured the effectiveness of the training?

- **Communications about Misconduct** – What has senior management done to let employees know the company's position on the misconduct that occurred? What communications have there been generally when an employee is terminated for failure to comply with the company's policies, procedures, and controls (*e.g.*, anonymized descriptions of the type of misconduct that leads to discipline)?

- **Availability of Guidance** – What resources have been available to employees to provide guidance relating to compliance policies? How has the company assessed whether its employees know when to seek advice and whether they would be willing to do so?

7. Confidential Reporting and Investigation[6]

- **Effectiveness of the Reporting Mechanism** – How has the company collected, analyzed, and used information from its reporting mechanisms? How has the company assessed the seriousness of the allegations it received? Has the compliance function had full access to reporting and investigative information?

- **Properly Scoped Investigation by Qualified Personnel** – How has the company ensured that the investigations have been properly scoped, and were independent, objective, appropriately conducted, and properly documented?

- **Response to Investigations** – Has the company's investigation been used to identify root causes, system vulnerabilities, and accountability lapses, including among supervisory manager and senior executives? What has been the process for responding to investigative findings? How high up in the company do investigative findings go?

8. Incentives and Disciplinary Measures[7]

- **Accountability** – What disciplinary actions did the company take in response to the misconduct and when did they occur? Were managers held accountable for misconduct that occurred under their supervision? Did the company's response consider disciplinary actions for supervisors' failure in oversight? What is the company's record (*e.g.*, number and types of disciplinary actions) on employee discipline relating to the type(s) of conduct at issue? Has the company ever terminated or otherwise disciplined anyone (reduced or eliminated bonuses, issued a warning letter, etc.) for the type of misconduct at issue?

- **Human Resources Process** – Who participated in making disciplinary decisions for the type of misconduct at issue?

- **Consistent Application** – Have the disciplinary actions and incentives been fairly and consistently applied across the organization?

- **Incentive System** – How has the company incentivized compliance and ethical behavior? How has the company considered the potential negative compliance implications of its incentives and rewards? Have there been specific examples of actions taken (*e.g.*, promotions or awards denied) as a result of compliance and ethics considerations?

9. Continuous Improvement, Periodic Testing and Review[8]

- **Internal Audit** – What types of audits would have identified issues relevant to the misconduct? Did those audits occur and what were the findings? What types of relevant audit findings and remediation progress have been reported to management and the board on a regular basis? How have management and the board followed up? How often has internal audit generally conducted assessments in high-risk areas?

- **Control Testing** – Has the company reviewed and audited its compliance program in the area relating to the misconduct, including testing of relevant controls, collection and analysis of compliance data, and interviews of employees and third-parties? How are the results reported and action items tracked? What control testing has the company generally undertaken?

- **Evolving Updates** – How often has the company updated its risk assessments and reviewed its compliance policies, procedures, and practices? What steps has the company taken to determine whether policies/procedures/practices make sense for particular business segments/subsidiaries?

10. Third Party Management [9]

- **Risk-Based and Integrated Processes** – How has the company's third-party management process corresponded to the nature and level of the enterprise risk identified by the company? How has this process been integrated into the relevant procurement and vendor management processes?

- **Appropriate Controls** – What was the business rationale for the use of the third parties in question? What mechanisms have existed to ensure that the contract terms specifically described the services to be performed, that the payment terms are appropriate, that the described contractual work is performed, and that compensation is commensurate with the services rendered?

- **Management of Relationships** – How has the company considered and analyzed the third party's incentive model against compliance risks? How has the company monitored the third parties in question? How has the company trained the relationship managers about what the compliance risks are and how to manage them? How has the company incentivized compliance and ethical behavior by third parties?

- **Real Actions and Consequences** – Were red flags identified from the due diligence of the third parties involved in the misconduct and how were they resolved? Has a similar third party been suspended, terminated, or audited as a result of compliance issues? How has the company monitored these actions (*e.g.*, ensuring that the vendor is not used again in case of termination)?

11. Mergers and Acquisitions (M&A) [10]

- **Due Diligence Process** – Was the misconduct or the risk of misconduct identified during due diligence? Who conducted the risk review for the acquired/merged entities and how was it done? What has been the M&A due diligence process generally?

- **Integration in the M&A Process** – How has the compliance function been integrated into the merger, acquisition, and integration process?

- **Process Connecting Due Diligence to Implementation** – What has been the company's process for tracking and remediating misconduct or misconduct risks identified during the due diligence process? What has been the company's process for implementing compliance policies and procedures at new entities?

[1] USSG § 8B2.1(b)(3); FCPA Guide, p.57; USAM 9-28.800 Comment; OECD Handbook, C.1, p.16 *et seq*.

[2] USSG § 8B2.1(2)(B)-(C); FCPA Guide, p.58; USAM 9-28.800 Comment; OECD Handbook, C.3, p. 23 *et seq*.

[3] USSG § 8B2.1(b)(1); FCPA Guide, pp.57-58; OECD Handbook, C.4 and C.5, p.27 *et seq*.

[4] USSG § 8B2.1(b)(5)(7) and (c); USAM 9-28.800 Comment; OECD Handbook, B, p.10 *et seq*.

[5] USSG § 8B2.1(b)(4); FCPA Guide p. 59; USAM 9-28.800 Comment; OECD Handbook, C.8, p. 54 *et seq*.

[6] USSG § 8B2.1(b)(5)(C); FCPA Guide, p. 61; OECD Handbook, C.10, p.60 *et seq*.

[7] USSG § 8B2.1(b)(6); FCPA Guide, pp.59-60; USAM 9-28.800 Comment; OECD Handbook, C.11, p. 68 *et seq*.

[8] USSG § 8B2.1(b)(5)(A)(B); FCPA Guide, pp.61-62; USAM 9-28.800 Comment; OECD Handbook, C.12, pp.72 *et seq*.

[9] FCPA Guide, p.60-66; OECD Handbook, C.6, pp.38 *et seq*.

[10] FCPA Guide, p.62.

U.S. Department of Justice

Office of the Deputy Attorney General

The Deputy Attorney General

Washington, D.C. 20530

September 9, 2015

MEMORANDUM FOR THE ASSISTANT ATTORNEY GENERAL, ANTITRUST DIVISION
THE ASSISTANT ATTORNEY GENERAL, CIVIL DIVISION
THE ASSISTANT ATTORNEY GENERAL, CRIMINAL DIVISION
THE ASSISTANT ATTORNEY GENERAL, ENVIRONMENT AND NATURAL RESOURCES DIVISION
THE ASSISTANT ATTORNEY GENERAL, NATIONAL SECURITY DIVISION
THE ASSISTANT ATTORNEY GENERAL, TAX DIVISION
THE DIRECTOR, FEDERAL BUREAU OF INVESTIGATION
THE DIRECTOR, EXECUTIVE OFFICE FOR UNITED STATES TRUSTEES
ALL UNITED STATES ATTORNEYS

FROM: Sally Quillian Yates
Deputy Attorney General

SUBJECT: Individual Accountability for Corporate Wrongdoing

Fighting corporate fraud and other misconduct is a top priority of the Department of Justice. Our nation's economy depends on effective enforcement of the civil and criminal laws that protect our financial system and, by extension, all our citizens. These are principles that the Department lives and breathes—as evidenced by the many attorneys, agents, and support staff who have worked tirelessly on corporate investigations, particularly in the aftermath of the financial crisis.

One of the most effective ways to combat corporate misconduct is by seeking accountability from the individuals who perpetrated the wrongdoing. Such accountability is important for several reasons: it deters future illegal activity, it incentivizes changes in corporate behavior, it ensures that the proper parties are held responsible for their actions, and it promotes the public's confidence in our justice system.

There are, however, many substantial challenges unique to pursuing individuals for corporate misdeeds. In large corporations, where responsibility can be diffuse and decisions are made at various levels, it can be difficult to determine if someone possessed the knowledge and criminal intent necessary to establish their guilt beyond a reasonable doubt. This is particularly true when determining the culpability of high-level executives, who may be insulated from the day-to-day activity in which the misconduct occurs. As a result, investigators often must reconstruct what happened based on a painstaking review of corporate documents, which can number in the millions, and which may be difficult to collect due to legal restrictions.

These challenges make it all the more important that the Department fully leverage its resources to identify culpable individuals at all levels in corporate cases. To address these challenges, the Department convened a working group of senior attorneys from Department components and the United States Attorney community with significant experience in this area. The working group examined how the Department approaches corporate investigations, and identified areas in which it can amend its policies and practices in order to most effectively pursue the individuals responsible for corporate wrongs. This memo is a product of the working group's discussions.

The measures described in this memo are steps that should be taken in any investigation of corporate misconduct. Some of these measures are new, while others reflect best practices that are already employed by many federal prosecutors. Fundamentally, this memo is designed to ensure that all attorneys across the Department are consistent in our best efforts to hold to account the individuals responsible for illegal corporate conduct.

The guidance in this memo will also apply to civil corporate matters. In addition to recovering assets, civil enforcement actions serve to redress misconduct and deter future wrongdoing. Thus, civil attorneys investigating corporate wrongdoing should maintain a focus on the responsible individuals, recognizing that holding them to account is an important part of protecting the public fisc in the long term.

The guidance in this memo reflects six key steps to strengthen our pursuit of individual corporate wrongdoing, some of which reflect policy shifts and each of which is described in greater detail below: (1) in order to qualify for any cooperation credit, corporations must provide to the Department all relevant facts relating to the individuals responsible for the misconduct; (2) criminal and civil corporate investigations should focus on individuals from the inception of the investigation; (3) criminal and civil attorneys handling corporate investigations should be in routine communication with one another; (4) absent extraordinary circumstances or approved departmental policy, the Department will not release culpable individuals from civil or criminal liability when resolving a matter with a corporation; (5) Department attorneys should not resolve matters with a corporation without a clear plan to resolve related individual cases, and should

memorialize any declinations as to individuals in such cases; and (6) civil attorneys should consistently focus on individuals as well as the company and evaluate whether to bring suit against an individual based on considerations beyond that individual's ability to pay.[1]

I have directed that certain criminal and civil provisions in the United States Attorney's Manual, more specifically the Principles of Federal Prosecution of Business Organizations (USAM 9-28.000 *et seq.*) and the commercial litigation provisions in Title 4 (USAM 4-4.000 *et seq.*), be revised to reflect these changes. The guidance in this memo will apply to all future investigations of corporate wrongdoing. It will also apply to those matters pending as of the date of this memo, to the extent it is practicable to do so.

1. To be eligible for <u>any</u> cooperation credit, corporations must provide to the Department all relevant facts about the individuals involved in corporate misconduct.

In order for a company to receive <u>any</u> consideration for cooperation under the Principles of Federal Prosecution of Business Organizations, the company must completely disclose to the Department all relevant facts about individual misconduct. Companies cannot pick and choose what facts to disclose. That is, to be eligible for any credit for cooperation, the company must identify all individuals involved in or responsible for the misconduct at issue, regardless of their position, status or seniority, and provide to the Department all facts relating to that misconduct. If a company seeking cooperation credit declines to learn of such facts or to provide the Department with complete factual information about individual wrongdoers, its cooperation will not be considered a mitigating factor pursuant to USAM 9-28.700 *et seq.*[2] Once a company meets the threshold requirement of providing all relevant facts with respect to individuals, it will be eligible for consideration for cooperation credit. The extent of that cooperation credit will depend on all the various factors that have traditionally applied in making this assessment (*e.g.*, the timeliness of the cooperation, the diligence, thoroughness, and speed of the internal investigation, the proactive nature of the cooperation, etc.).

This condition of cooperation applies equally to corporations seeking to cooperate in civil matters; a company under civil investigation must provide to the Department all relevant facts about individual misconduct in order to receive any consideration in the negotiation. For

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[1] The measures laid out in this memo are intended solely to guide attorneys for the government in accordance with their statutory responsibilities and federal law. They are not intended to, do not, and may not be relied upon to create a right or benefit, substantive or procedural, enforceable at law by a party to litigation with the United States.

[2] Nor, if a company is prosecuted, will it support a cooperation-related reduction at sentencing. *See* U.S.S.G. USSG § 8C2.5(g), Application Note 13 ("A prime test of whether the organization has disclosed all pertinent information" necessary to receive a cooperation-related reduction in its offense level calculation "is whether the information is sufficient ... to identify ... the individual(s) responsible for the criminal conduct").

example, the Department's position on "full cooperation" under the False Claims Act, 31 U.S.C. § 3729(a)(2), will be that, at a minimum, all relevant facts about responsible individuals must be provided.

The requirement that companies cooperate completely as to individuals, within the bounds of the law and legal privileges, *see* USAM 9-28.700 to 9-28.760, does not mean that Department attorneys should wait for the company to deliver the information about individual wrongdoers and then merely accept what companies provide. To the contrary, Department attorneys should be proactively investigating individuals at every step of the process – before, during, and after any corporate cooperation. Department attorneys should vigorously review any information provided by companies and compare it to the results of their own investigation, in order to best ensure that the information provided is indeed complete and does not seek to minimize the behavior or role of any individual or group of individuals.

Department attorneys should strive to obtain from the company as much information as possible about responsible individuals before resolving the corporate case. But there may be instances where the company's continued cooperation with respect to individuals will be necessary post-resolution. In these circumstances, the plea or settlement agreement should include a provision that requires the company to provide information about all culpable individuals and that is explicit enough so that a failure to provide the information results in specific consequences, such as stipulated penalties and/or a material breach.

2. Both criminal and civil corporate investigations should focus on individuals from the inception of the investigation.

Both criminal and civil attorneys should focus on individual wrongdoing from the very beginning of any investigation of corporate misconduct. By focusing on building cases against individual wrongdoers from the inception of an investigation, we accomplish multiple goals. First, we maximize our ability to ferret out the full extent of corporate misconduct. Because a corporation only acts through individuals, investigating the conduct of individuals is the most efficient and effective way to determine the facts and extent of any corporate misconduct. Second, by focusing our investigation on individuals, we can increase the likelihood that individuals with knowledge of the corporate misconduct will cooperate with the investigation and provide information against individuals higher up the corporate hierarchy. Third, by focusing on individuals from the very beginning of an investigation, we maximize the chances that the final resolution of an investigation uncovering the misconduct will include civil or criminal charges against not just the corporation but against culpable individuals as well.

3. Criminal and civil attorneys handling corporate investigations should be in routine communication with one another.

Early and regular communication between civil attorneys and criminal prosecutors handling corporate investigations can be crucial to our ability to effectively pursue individuals in

these matters. Consultation between the Department's civil and criminal attorneys, together with agency attorneys, permits consideration of the full range of the government's potential remedies (including incarceration, fines, penalties, damages, restitution to victims, asset seizure, civil and criminal forfeiture, and exclusion, suspension and debarment) and promotes the most thorough and appropriate resolution in every case. That is why the Department has long recognized the importance of parallel development of civil and criminal proceedings. *See* USAM 1-12.000.

Criminal attorneys handling corporate investigations should notify civil attorneys as early as permissible of conduct that might give rise to potential individual civil liability, even if criminal liability continues to be sought. Further, if there is a decision not to pursue a criminal action against an individual – due to questions of intent or burden of proof, for example – criminal attorneys should confer with their civil counterparts so that they may make an assessment under applicable civil statutes and consistent with this guidance. Likewise, if civil attorneys believe that an individual identified in the course of their corporate investigation should be subject to a criminal inquiry, that matter should promptly be referred to criminal prosecutors, regardless of the current status of the civil corporate investigation.

Department attorneys should be alert for circumstances where concurrent criminal and civil investigations of individual misconduct should be pursued. Coordination in this regard should happen early, even if it is not certain that a civil or criminal disposition will be the end result for the individuals or the company.

4. Absent extraordinary circumstances, no corporate resolution will provide protection from criminal or civil liability for any individuals.

There may be instances where the Department reaches a resolution with the company before resolving matters with responsible individuals. In these circumstances, Department attorneys should take care to preserve the ability to pursue these individuals. Because of the importance of holding responsible individuals to account, absent extraordinary circumstances or approved departmental policy such as the Antitrust Division's Corporate Leniency Policy, Department lawyers should not agree to a corporate resolution that includes an agreement to dismiss charges against, or provide immunity for, individual officers or employees. The same principle holds true in civil corporate matters; absent extraordinary circumstances, the United States should not release claims related to the liability of individuals based on corporate settlement releases. Any such release of criminal or civil liability due to extraordinary circumstances must be personally approved in writing by the relevant Assistant Attorney General or United States Attorney.

5. **Corporate cases should not be resolved without a clear plan to resolve related individual cases before the statute of limitations expires and declinations as to individuals in such cases must be memorialized.**

If the investigation of individual misconduct has not concluded by the time authorization is sought to resolve the case against the corporation, the prosecution or corporate authorization memorandum should include a discussion of the potentially liable individuals, a description of the current status of the investigation regarding their conduct and the investigative work that remains to be done, and an investigative plan to bring the matter to resolution prior to the end of any statute of limitations period. If a decision is made at the conclusion of the investigation not to bring civil claims or criminal charges against the individuals who committed the misconduct, the reasons for that determination must be memorialized and approved by the United States Attorney or Assistant Attorney General whose office handled the investigation, or their designees.

Delays in the corporate investigation should not affect the Department's ability to pursue potentially culpable individuals. While every effort should be made to resolve a corporate matter within the statutorily allotted time, and tolling agreements should be the rare exception, in situations where it is anticipated that a tolling agreement is nevertheless unavoidable and necessary, all efforts should be made either to resolve the matter against culpable individuals before the limitations period expires or to preserve the ability to charge individuals by tolling the limitations period by agreement or court order.

6. **Civil attorneys should consistently focus on individuals as well as the company and evaluate whether to bring suit against an individual based on considerations beyond that individual's ability to pay.**

The Department's civil enforcement efforts are designed not only to return government money to the public fisc, but also to hold the wrongdoers accountable and to deter future wrongdoing. These twin aims – of recovering as much money as possible, on the one hand, and of accountability for and deterrence of individual misconduct, on the other – are equally important. In certain circumstances, though, these dual goals can be in apparent tension with one another, for example, when it comes to the question of whether to pursue civil actions against individual corporate wrongdoers who may not have the necessary financial resources to pay a significant judgment.

Pursuit of civil actions against culpable individuals should not be governed solely by those individuals' ability to pay. In other words, the fact that an individual may not have sufficient resources to satisfy a significant judgment should not control the decision on whether to bring suit. Rather, in deciding whether to file a civil action against an individual, Department attorneys should consider factors such as whether the person's misconduct was serious, whether

it is actionable, whether the admissible evidence will probably be sufficient to obtain and sustain a judgment, and whether pursuing the action reflects an important federal interest. Just as our prosecutors do when making charging decisions, civil attorneys should make individualized assessments in deciding whether to bring a case, taking into account numerous factors, such as the individual's misconduct and past history and the circumstances relating to the commission of the misconduct, the needs of the communities we serve, and federal resources and priorities.

Although in the short term certain cases against individuals may not provide as robust a monetary return on the Department's investment, pursuing individual actions in civil corporate matters will result in significant long-term deterrence. Only by seeking to hold individuals accountable in view of all of the factors above can the Department ensure that it is doing everything in its power to minimize corporate fraud, and, over the course of time, minimize losses to the public fisc through fraud.

Conclusion

The Department makes these changes recognizing the challenges they may present. But we are making these changes because we believe they will maximize our ability to deter misconduct and to hold those who engage in it accountable.

In the months ahead, the Department will be working with components to turn these policies into everyday practice. On September 16, 2015, for example, the Department will be hosting a training conference in Washington, D.C., on this subject, and I look forward to further addressing the topic with some of you then.

CADWALADER

Cadwalader, Wickersham & Taft LLP
www.cadwalader.com

The Clock Is Ticking: Companies Need to Comply Now with New DFS Cybersecurity Rules in New York

Strict new cybersecurity rules – described by the New York Department of Financial Services (DFS) as "first-in-nation" in terms of their scope and requirements – became effective in New York on March 1, 2017. Entities covered by the new rules ("covered entities") now have just months to comply – or potentially face harsh penalties.

What Entities are Covered by the New Rules?

With limited exceptions, the rules apply to businesses regulated by the DFS, which include a wide range of insurance, banking, and financial services companies. Third party service provides, while not expressly covered by the rules, will also be required to adopt robust cybersecurity risk management programs if they wish to continue to do business with covered entities.

- Financial Institutions
- Banks
- Insurance Compaines

What Happens if Covered Entities Fail to Comply with the New Rules?

It remains to be seen how aggressively the DFS will pursue entities that fail to comply with the new rules. However, the DFS has imposed large fines on financial institutions in other areas, such as with anti-money laundering laws. Under the rules, DFS can demand that covered entities produce for inspection all documents and information relevant to a covered entity's cybersecurity program.

Interested in learning more?

Cadwalader would be pleased to present a customized CLE program in your office or as a webinar.

Jennifer Olson

+1 212 993 2990

jennifer.olson@cwt.com

DEADLINES

The rules will be phased in over a period of two years after their effective date (March 1, 2017), with the following important deadlines for covered entities:

1st Deadline

August 28, 2017

- Adopt written cybersecurity policies and procedures, including an incident response plan.
- Designate a Chief Information Security Officer (CISO) and retain qualified cybersecurity personnel.
- Notify DFS within 72 hours of determining that a cybersecurity event has occurred.
- Ensure that only appropriate personnel may access confidential non public data.

2nd Deadline

February 15, 2018

- Submit annual compliance certifications, signed by a senior officer, to DFS.

3rd Deadline

March 1, 2018

- Implement multi-factor authentication.
- Conduct regular penetration testing and risk assessments.
- Implement cybersecurity awareness training.

4th Deadline

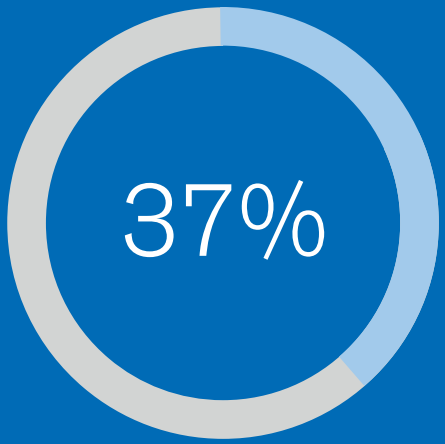
September 1, 2018

- Encrypt confidential data
- Monitor user activity.
- Implement secure data disposal procedures.
- Maintain audit trails for network activity and significant transactions.

Final Deadline

March 1, 2019

Adopt comprehensive cybersecurity risk management programs for third party service providers.



Only 37% of businesses report having a fully-operational incident response plan. (*Source: 2016 PwC survey of businesses*)

Cadwalader's interdisciplinary cybersecurity team is led by:

John T. Moehringer
Partner – New York
Intellectual Property
+1 212 504 6731
john.moehringer@cwt.com

Joseph V. Moreno
Partner – Washington, DC
White Collar Defense and Investigations
+1 202 862 2262
joseph.moreno@cwt.com

Joseph Facciponti
Special Counsel – New York
Corporate and Financial Services
Litigation and Regulation
+1 212 504 6313
joseph.facciponti@cwt.com

Fund Finance Market Update

Wesley Misson

Subscription lines: opportunities multiply as they are seized

Subscription lines to funds have been hitting the headlines recently. In this article, Fi Dinh, Relationship Director within the Private Equity team at Barclays, alongside Jeremy Cross, Partner, Co-leader of Global Fund Finance at Cadwalader, Wickersham & Taft LLP, take a closer look at the benefits of the subscription line and the concerns expressed in recent publications, and give their views on the future usage.

Initially used purely for short-term bridging of capital calls, over recent years, subscription lines have become longer term; their range of applications has expanded, ticket sizes have increased, and their use has become more or less ubiquitous, encouraged by both increasing demand by funds wishing to make use of them as well as lenders looking to provide them.

Current estimates of market size are that subscription facilities account for around $200bn in the US alone, with significant volume also in the UK and Europe, and increasingly in Asia (Preqin). It's clear that subscription lines are popular, but the growth in the market has caused an increasing level of concern from the investors who both commit to the funds and will ultimately be asked to pay for those lines.

Why use subscription lines?

One of the primary benefits of subscription lines is their ability to smooth out investor calls and provide predictability of cash flow for both funds and their investors. Historically used mainly to finance investment activity between the first and final close, thereby avoiding the administrative burden associated with reconciliation, subline facilities have evolved to be used by funds of different strategies for widely different purposes.

Whilst buyout funds continue to use these facilities primarily as an easy and quick means of funding an investment prior to calling capital a few months later, real estate and infrastructure funds often appreciate the ability to use these facilities for issuance of guarantees or letters of credit to back asset-level arrangements.

In the meantime, credit and secondary funds value the ability to ramp up their investments and consolidate capital calls, given the sheer volume of deals at any one time. The facilities are also used as a key component in a fund's investment and portfolio management toolbox; the fact that they're multi-currency provides a natural hedge against foreign exchange movement, and the transparent pricing structure enables some certainty over the cost of funding for both individual deal and fund-level IRR calculation.

Beneficial outcomes all round

A secondary benefit of subscription lines is they enhance IRR (internal rate of return) and have a positive effect on the 'J curve'. If these enhancements are properly understood and accounted for by investors and funds, these outcomes are of benefit to both.

Finally, subscription facilities are not 'leverage', and credit decisions made on these facilities generally look to a pool of fairly significant and well-funded investors. The lack of leverage makes the product somewhat less 'complex' from the regulators' perspective and, done right, the credit is relatively 'good' credit. These two factors therefore make the costs of utilising these types of facilities considerably lower for lenders, and consequently funds/investors, than many other 'leverage' type credit lines.

A look at some of the concerns

Cost

The fund pays fees and interest to a bank, reducing the bottom line profitability of that fund and its investors, although, as stated above, the costs of subscription lines in comparison to many other facilities are relatively low. However, the question for the fund and the investors is whether the benefits of the financing outweigh the cost.

Reduction in the hurdle for payment of incentive fees

This is a commonly expressed area of concern for investors when considering using subscription lines – particularly in relation to IRR enhancement. This is a legitimate concern when reviewing the level the hurdle is set at so that the subscription line makes that hurdle easier to achieve without any particular improvement in underlying performance. However, it must not be forgotten that the hurdle rate in and of itself is an arbitrary number, and the market has developed over recent years so that investors have become increasingly attentive to all aspects of a fund's and its manager's or general partner's performance. Investors are also increasingly well aware of the impact of financing. Since the financial crisis, Limited Partnership Agreements (LPAs) and equivalent fund documentation are increasingly drafted, to cater specifically to subscription financing, its scope, treatment and disclosure, including appropriate escrow and claw-back mechanism. Hurdles should be set appropriately and on an informed basis for such financing.

Lowering of standards applied to investments

Funds are answerable to a number of 'interested parties' (first and foremost their investors) and they have a number of concerns to meet when it comes to implementing their investment policies. Although there are exceptions, it is true that, in a subscription line, a Lender will not generally impose particular parameters or covenants around the funds' investments; however, given the investor scrutiny now being applied to funds (in addition to the level of competition between funds), we see limited potential for a lowering of standards.

It is also our experience that funds and investors will usually impose strict limits on the amount of investor commitments that can actually be the subject of financing (often no higher than around 30%), so it is difficult to see how the availability of this type of credit would substantively change either fund or manager/GP behaviour in this way. Deviations from the fund's investment policy might come about as a result of factors entirely unrelated to the financing itself, for example from the macro environment, increased competition, excess dry powder and shortage of high-quality assets at sensible pricing.

Increased UBTI (unrelated business taxable income) risk

Our experience is that investors and funds are well aware of this risk and, for many years, they have specifically 'structured around' it in any financing, for example through the use of UBTI 'blockers' in the fund or finance structure and/or by including 'clean downs' in the LPA or private placement memorandum to mitigate any such risk.

Increased risk around investor transfers

This may be more of a theoretical risk, rather than a practical one, depending largely on the type of funding available. Subscription financing tends to be divided between fairly well-defined 'borrowing base' funding for investors (based on ratings or equivalents) and a more 'discretionary' or 'leverage' model. With a borrowing base model, the parameters should mean that transfers are unlikely to significantly affect the availability of the financing. If they do, it will create a timing issue for the period, meaning that the banks will need to analyse the new LPs for their potential inclusion in the borrowing base. With a more discretionary or leverage base, there are usually ways to structure around this, for example by ensuring that all current investors in a fund are approved. It is also important to note that in the majority of financings (although not all), the base of investors is relatively broad, so in the absence of significant transfers between numbers of investors, it is unlikely that there will ever be a real issue. It is also worth emphasising that, generally speaking, lenders do not look to control transfers in any way over and beyond whatever controls (or discretions) are contained in the fund documentation itself.

Desire for greater 'transparency' from investors and disparity between investors

Lenders have sought more detailed information both on and from investors – something that investors have pushed back on. The recent trend in both the US and Europe is for more limited information to be provided by investors to lenders, and for investors to be less 'involved' in any funding issues. For example, the use of investor letters (once very common, particularly in the US) is increasingly rare, except for those funds with highly concentrated investor bases. In general, there is an acceptance among lenders that they will have only limited access to investor information and, again, this is limited by what is generally set out in the LPA. When it comes to investor appetite for different forms of borrowing, we see this as an issue, which needs to be structured around. Often this can be resolved through the use of parallel or feeder funds and alternative investment vehicles, whereby investors can choose between a 'borrowing' vehicle or a 'non-borrowing vehicle'.

Distortion of fund metrics

The use of subscription lines can clearly enhance IRR simply by using debt where investor commitments would otherwise have been required. However, IRR is only one metric and, by itself, doesn't necessarily determine 'good' or 'bad' performance by a fund. In addition (as stated above), properly informed investors (most investors in these funds are more than well informed) are often well aware of the potential enhancements and will ensure that these are taken into account. The perceived improvement in IRRs and reduction of the J-curve at the outset will then be balanced out by lower multiples over the longer term. As a result, the focus will be on the impact of such financing at the start of the fund's life, rather than throughout its life, which is normally long-term in nature. The ILPA paper referenced at the beginning of this article makes sensible recommendations as to how a particular fund's investors – as well as the market more generally – can be made aware of what effect a subscription line may have on fund performance.

A 'race to the bottom' by lenders of subscription lines and funds

On this point, the concern is that it leads to looser terms and, in effect, encourages bad decisions by fund managers and executives; however, we see no evidence of this in the last 30 years of the subscription finance market. We do see evidence of increasing price competition (and we see lenders using different general approaches in the market), but we do not believe that this type of financing actually lends itself well to such a 'race'. There are two reasons for this. The first is that, while there is clearly competition (including on pricing), a fund is quite a complex animal and lenders who have been through both the experience of the 2007–2008 financial crisis, as well as many years of increased focus both internally and externally on credit, are simply not in a position to take big risks on subscription lending. The second reason is that investors will simply not let it happen. Although there are examples of funds not subject to borrowing caps, we very rarely see a fund with anything higher than a 30% cap on total commitments for lending. Having said that, things may now be changing as a result of the recent influx of new providers entering the subscription lending market from Europe, America and Asia. It is the responsibility of not only the banks, but also the GPs, LPs and professional adviser community to ensure that market standards are upheld in these transactions, and that any distorted behaviour is called out and discouraged.

Systemic risks

The two key issues here can be summarised in two parts: firstly, the concern that, when called, investors will not be in a position to pay. The second relates to the nature of subscription financing (where it is used to delay or postpone the need for the fund to call capital directly from investors, sometimes for a significant period of time and sometimes across several investments). The concern is that when the investor is finally called (often to repay the subscription facility), they may not be in a position to pay and/or the amount called from the investor will be a significant amount of (or all of) that investor's total commitment. How real a risk is this? We have already been through one great financial crisis and, as far as we know, there were no defaults in this particular industry during that time, despite some clear issues with many funds' investments; many of the funds that did suffer these types of issues actually repaid their facilities in full around that time. We are also anecdotally aware that over the 20 to 30 years that this type of financing has been available, there have been similar low or non-existent default levels, despite three or four significant recessions during the same period. On the related point of investor commitments 'stacking up', we see a number of methods being used by lenders (as well as funds and investors) to mitigate that risk, including regular clean-downs, semi-annual or annual capital call requirements, plus the inclusion of certain fund performance triggers (often negotiated by the investors themselves and included in the LPA or side letters).

Subscription lines and their future

As with all forms of financing, too much is not necessarily a good thing and not enough may be a bad thing. There are legitimate concerns being raised by investors (Howard Marks and ILPA, among others, have both very effectively analysed those concerns) and we believe these are well understood. Funds and their lenders should all be aware of the concerns and take them into account in any financing proposition.

As stated at the beginning of this article, we believe that the increased scrutiny on these subscription facilities (particularly by investors), alongside greater transparency – along the lines set out in the ILPA paper – will be a welcome development. Properly used, subscription financing is a product that enhances the funds market and the investment market. It is absolutely right that all those involved should be aware of the terms and the risks; it is not for everybody and it is not a panacea, but, when properly and openly used, we are confident that the product will continue to develop to fulfil market needs and help the market grow.

Fi Dinh

Relationship Director
Private Equity

Fi is a Relationship Director within Barclays' European Private Equity Funds team, based in London. The team provides finance, derivatives, trade finance and onshore and offshore banking for funds in the buy-out, real estate, infrastructure, debt and secondaries sectors.

Fi has nearly a decade of banking experience across operational risk, credit analysis, structuring and origination in the UK and Middle East. Fi was the first member of the PE specialist coverage team at Barclays and has supported financial sponsors in structuring facilities in the US, Europe, Asia and Africa.

Prior to joining Barclays in 2011, Fi worked for a number of governments in nation-branding projects, particularly around media relations, attracting foreign direct investment and crisis management. Fi holds a BA (Hons) in Public Relations from the London College of Communication, University of the Arts London, a Diploma in Fine Arts and a Professional Diploma in Banking Practice & Management.

Jeremy Cross

Partner
Co-leader of Global Fund Finance at Cadwalader, Wickersham & Taft LLP

Jeremy is a vastly experienced funds finance lawyer and has been active in the UK funds finance market (acting for both lenders and funds) for over 14 years. During that time he has worked with most of the major lenders in the market, including Royal Bank of Scotland, Lloyds Banking Group, Barclays Bank, Wells Fargo, Bank of America, National Australia Bank, CACEIS and CBA, along with a number of other banks, non-bank financial institutions and funds. In addition to his "UK" experience, Jeremy has also worked frequently on "US" funds financing structures and documentation.

Chambers UK lists Jeremy as a leader in the field of Banking & Finance, described as "a highly intelligent and commercial figure". Legal 500 has recommended the "very commercial [Jeremy Cross]". He is also recommended in Bank Lending, noted as "very commercial and has the ability to explain in simple language often difficult concepts". Jeremy was included among the "Hot 100" Lawyers by The Lawyer in 2013.

He was awarded an Exhibition to and received his MA in Law from Cambridge University. Jeremy is admitted to practise in England and Wales.

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Michael C. Mascia

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USA

Michael C. Mascia, Wesley A. Misson & Jeremy Cross
Cadwalader, Wickersham & Taft LLP

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.

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,

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

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.

Investor influence on structuring

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

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

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

New margin regulations

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

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

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

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

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.

Acknowledgment

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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*

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).

Michael C. Mascia
Tel: +1 704 348 5160 / Email: michael.mascia@cwt.com

Mike Mascia is a partner in the firm's Capital Markets Group. He has extensive experience representing a variety of lenders across a range of secured lending transactions, with particular emphasis on the financing of investment funds and financial institutions. He has a globally recognized practice in the subscription credit facility space, having represented both balance sheet and commercial paper conduit lenders in facilities to real estate and private equity funds sponsored by many of the world's pre-eminent fund sponsors.

Mike has represented the lead arrangers in many of the largest subscription credit facilities ever consummated. He has been lead counsel on numerous hybrid facilities, and is one of the few attorneys in the United States with experience in both subscription credit facilities and CLOs. Mike represents lenders on leverage facilities to secondary funds and other credits looking primarily to fund assets for repayment. Many of his transactions are cross-border in nature, and he is well-versed in the nuances of multi-jurisdictional transactions.

Wesley A. Misson
Tel +1 704 348 5355 / Email: wesley.misson@cwt.com

Wes Misson is a partner in the firm's Capital Markets Group. Wes's practice focuses on fund finance, and he has represented financial institutions as lenders and lead agents in hundreds of subscription credit facilities and other fund financings during the course of his career. His experience encompasses both subscription and hybrid facilities and includes working with fund-related borrowers on the negotiation of third-party investor documents with institutional, high net worth and sovereign wealth investors.

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.

Jeremy Cross
Tel +44 20 7170 8530 / Email: jeremy.cross@cwt.com

Jeremy Cross is a partner in the firm's Capital Markets Group. He is a vastly experienced loan finance lawyer with particular experience in fund finance and real estate finance as well as more general experience in acquisition, leverage and general corporate finance. Jeremy acts for lenders, borrowers and sponsors on a wide range of domestic and international financing transactions. His clients include the Royal Bank of Scotland, Lloyds Banking Group, Barclays Bank, Wells Fargo and National Australia Bank along with a number of other banks, non-bank financial institutions and funds. Chambers UK lists Jeremy as a leader in the field of Banking & Finance, described as "a highly intelligent and commercial figure". *The Legal 500* has recommended the "very commercial [Jeremy Cross]."

Cadwalader, Wickersham & Taft LLP

227 West Trade Street, Charlotte, NC 28202, USA
Tel: +1 704 348 5355 / Fax: +1 704 348 5200 / URL: www.cadwalader.com

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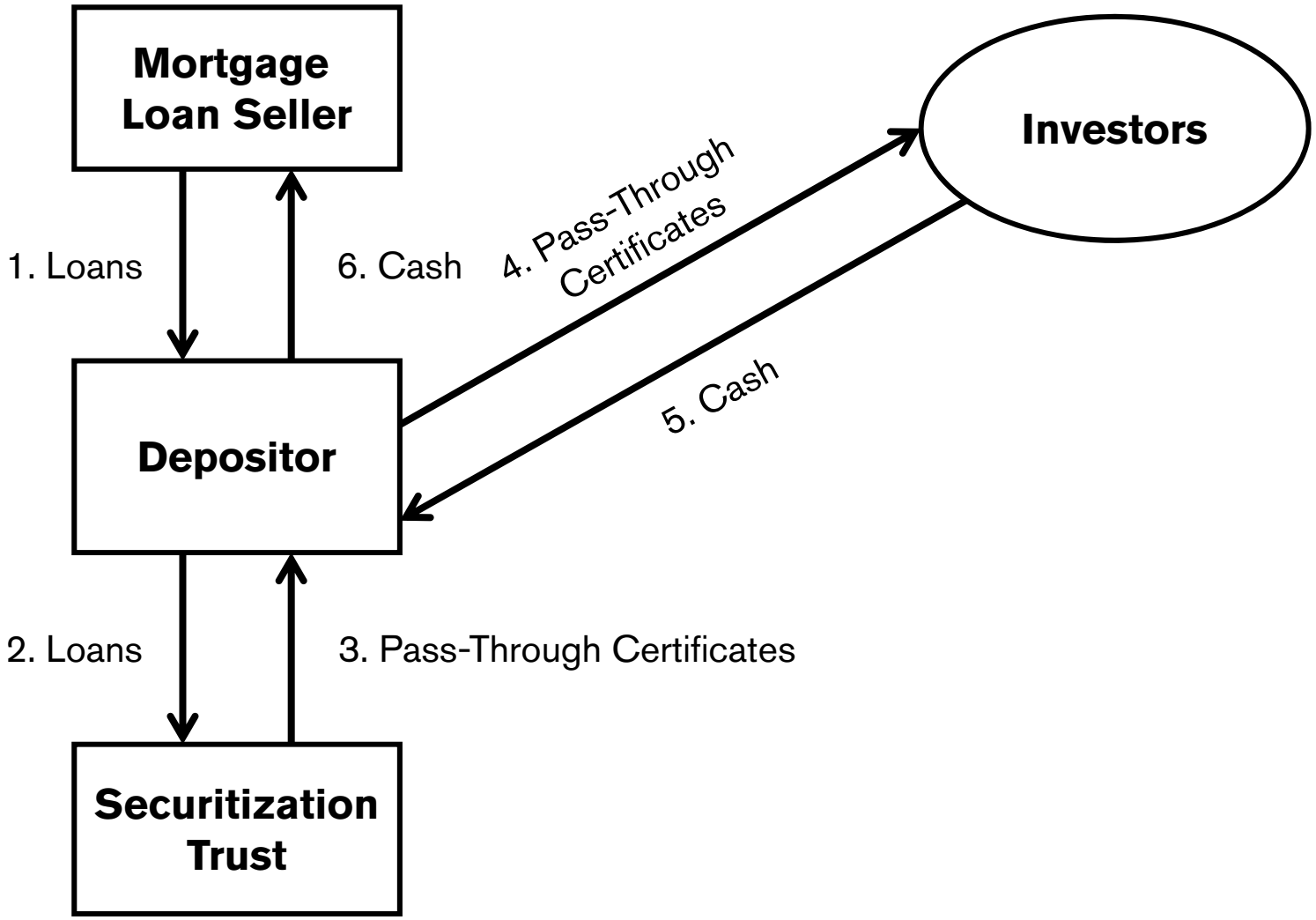
Typical CMBS Organization



Pooling and Servicing Agreement

- Transfers Loans from Depositor to Trust
- Assigns Loan Level Representations & Warranties to Trustee
- Servicing of Loans and Properties
- Issuance of Certificates
- Payments and Reporting to Investors

Pooling and Servicing Agreement (CONT'D)

- Trustee
  - Acts as Representative of Certificateholders
  - Beneficiary of Loan Seller Representations
  - Makes Distributions to Investors
  - Provides Reports to Investors
  - Custodian of Loan Documents
- Primary Servicer
  - Collects Payments on Loans
  - Primary Contact for Borrowers
  - Prepares Loan and Property-level Reports
  - Monitors Tax and Insurance Payments

Pooling and Servicing Agreement (CONT'D)

- Master Servicer
  - Oversees all Primary Servicers
  - Collects Loan Payments from Primary Servicers and Remits to Trustee
  - Prepares Aggregate Reports Used to Create Investor Reports
  - Responsible for Advancing of Delinquent Payments
    - Debt Service
    - Property Protection Advances (tax, insurance, emergency repairs, etc.)

Pooling and Servicing Agreement (CONT'D)

- Special Servicer
  - Responsible for Servicing of Troubled Loans
    - Loans delinquent in Payment by 60 days
    - Loans where Balloon Payment is not made
    - Borrower Bankruptcy
    - Certain other Events
  - Responsible for "working-out" Mortgage Loans with Borrowers or Foreclosing on Mortgaged Properties
  - Responsible for Managing and Liquidating Property when the Trust has Foreclosed
  - Follows directions of the Controlling Holder, subject to a servicing standard override
- Operating Advisor/Asset Representations Reviewer
  - Provides oversight of the Special Servicer/Majority Subordinate Certificateholder relationship in public securitizations

Rights of Certain Members in CMBS Transactions

- Majority Subordinate Certificateholder
  - Is the holder of the most subordinate class of control-eligible certificates not subject to a Control Appraisal Period
  - Has Consent and Consultation rights, including:
    - foreclosure
    - modification of a mortgage loan resulting in a discounted pay-off
    - modification of a monetary term of the Mortgage Loan
    - approving any bankruptcy plan of the Borrower
    - waiver of a due on sale or due on encumbrance provision
  - Has Right to remove and replace special servicer
- Other Certificateholders
  - no independent right to take action with respect to the Mortgage Loan
  - can obtain the names of other certificateholders upon request

Servicing Discussion Points

- How can the CMBS industry improve response time for borrower requests?
- Is there a better way to structure servicer compensation?

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The CLO Market: Current Issues and Trends

Neil Weidner

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Risk Retention Financing

November 8, 2017

OVERVIEW

- Section 941 of The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "*Dodd-Frank Act*"), codified as Section 15G of the Securities Exchange Act of 1934, as amended ("*Section 15G*"), mandates rules for credit risk retention

- On October 21-22, 2014, the federal regulatory agencies responsible for implementing regulations under the Dodd-Frank Act finalized the credit risk retention rules for ABS transactions (the "*Final Rules*")

- The Final Rules:

    - became effective with respect to RMBS on December 24, 2015

    - became effective with respect to all other ABS, *including CLOs*, on December 24, 2016

THE FINAL RULES – RETENTION REQUIREMENT

- The Final Rules generally require the ***sponsor*** of a securitization transaction (or ***majority-owned affiliate*** of the sponsor) to retain an economic interest in the credit risk of the securitized assets, unless otherwise exempted

  - "***Sponsor***" under the Final Rules means "a person who organizes and initiates a securitization transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity"

    - *A CLO manager is viewed as the sponsor by the joint regulators*

  - "***Majority-owned affiliate***" under the Final Rules means, with respect to a person, "an entity (other than the issuing entity) that, directly or indirectly, majority controls, is majority controlled by or is under common majority control with, such person. For purposes of this definition, majority control means ownership of more than 50 percent of the equity of an entity, or ownership of any other controlling financial interest in the entity, as determined under GAAP"

THE FINAL RULES – FORMS & AMOUNT OF RISK RETENTION

- Except as otherwise provided in the Final Rules, a sponsor must retain an economic interest in one of the following forms:
  - Vertical Risk Retention
  - Horizontal Risk Retention
  - Combined Eligible Vertical and Horizontal Retained Interest (*i.e.*, "L-shaped")
    - So long as the percentage of the face value of the vertical risk portion and the fair value of the horizontal risk portion are at least equal to 5%

THE FINAL RULES – RESTRICTIONS ON HEDGING, TRANSFER & FINANCING

- Hedging Prohibition
  - The Final Rules generally prohibit a sponsor and its affiliates from directly or indirectly hedging the credit risk that the sponsor is required to retain
- Transfer Prohibition
  - The Final Rules generally prohibit a sponsor from selling or otherwise transferring any interest that the sponsor is required to retain to any person other than a majority-owned affiliate of the sponsor (and each majority-owned affiliate is subject to the same restrictions)
- Sunset Prohibition
  - The hedging and transfer restrictions expire (in the case of securitizations other than RMBS) on or after the latest of:
    - the principal balance of the securitized assets falls to 33% of the closing date level;
    - the principal balance of the ABS interests issued in the securitization transaction fall to 33% of closing date level; and
    - two years after the closing date

- Forms of financing
    - Bi-lateral loan agreements
    - Resecuritizations
    - Repos

- Issues
  - Foreclosure rights
    - Provisions heavily negotiated
  - Full recourse
    - A sponsor and its affiliates are prohibited from pledging as collateral for any obligation (including a loan, repurchase agreement or other financing transaction) any retention interest that the sponsor is required to retain unless the obligation is with full recourse to the sponsor or its affiliate, as applicable
- Limited number of lenders

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