GLI GLOBAL LEGAL INSIGHTS

Fund Finance 2022

Sixth Edition

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Backleverage financings: Insights into the margin loan

Mimi Cheng, Jennifer Levitt & Jonathan Lindabury
Simpson Thacher & Bartlett LLP

Introduction

Over the recent years, there has been an increase in the use of backleverage products, such as margin loans, as a tool for leverage by sophisticated borrowers. Conceptually, margin loans have always been a part of the catalogue of leverage products available, but it was not until the mid-2010s that it became more common for private fund sponsors to use margin loan financings for their unique structures and specific needs. In this chapter, we will discuss the key elements comprising a typical margin loan facility, explore some of the reasons why margin loans are attractive to certain types of borrowers, and survey some of the mechanical elements that are implicated during the day-to-day maintenance of a margin loan facility.

Key elements of a margin loan

LTV

The basic tenet underlying all margin loans is an asset-backed loan driven by the loan-to-value (the "**LTV**") proposition: as the mark-to-market collateral value shifts on every date of determination (often daily), LTV on each such date also shifts. LTV is traditionally calculated by taking the amount of outstanding obligations accrued under a margin loan facility and dividing by the aggregate value of all collateral as of such time of determination.[1] At a certain level of increased LTV (such level, the "**Trigger LTV**"), a margin call or "collateral shortfall" will be triggered. Once triggered, the margin loan borrower must effect a cure by reducing LTV to a certain pre-determined level (the "**Reset LTV**").

In addition to margin calls, LTV also plays a role in gatekeeping certain other actions that a borrower might take that would reduce the collateral pool, oftentimes in the form of a *pro forma* test. For example, if a borrower seeks to sell pledged shares, a margin loan agreement may require that the borrower apply the proceeds therefrom to repay outstanding obligations such that the LTV, on a *pro forma* basis after giving effect to the release and sale of such shares, does not exceed a certain level. Or, if a borrower seeks to release cash on deposit in the pledged account (e.g., cash received from a distribution on the shares or otherwise previously deposited into the collateral account), a *pro forma* LTV test must similarly be satisfied, which is typically below the Reset LTV.

Collateral types

Collateral value forms the basis of the key LTV calculations in any margin loan facility, and valuation methods vary based on the nature of the underlying collateral. The most traditional type of margin loan collateral is common stock issued by a publicly traded company that is listed on a national exchange. Towards the most liquid end of the collateral spectrum, these types of freely tradeable securities provide the most reliable foreclosure

scenario for lenders, and are, as a result, the most common type of collateral. However, margin loan financings are also routinely extended on a host of other marketable securities, including preferred shares, convertible preferred shares, convertible notes and debt of public companies.

While the nature of collateral can differ between facilities, an essential underlying similarity is that there is some type of valuation method to track LTV, whether that be a public mark-to-market mechanic (e.g., by reference to the trading price on the relevant securities exchange) or by reference to some other type of valuation method, if a public mark is not available. For example, in recent years, the market has seen the development of private company margin loan financings, some on a pre-IPO basis while others on the expectation that the relevant issuer will remain a private company on a long-term basis. For these financings, the mark-to-market is hard to establish, and lenders instead typically rely on the value reported by the relevant sponsor investment vehicle (the "**Fund**") to its respective investors and creditors, commonly with highly negotiated appraisal (and sometimes dispute) rights. While more prevalent than in years past, these private company margin loan financings are less common and sometimes require additional elements of credit support from the relevant Fund.

Perfection of collateral

For lenders, the perfection of collateral is one of the most important elements of a financing from a risk perspective. Generally, lenders seek perfection by control, which affords them not only perfection but also priority under the Uniform Commercial Code. Depending on the type of collateral and how it is held, different alternatives are available for perfection. With respect to securities that are in "street name" and can be fully tradeable through the systems of the Depository Trust Company ("**DTC**"), such securities can be deposited into a securities account at any broker or custodial institution, with a control agreement in favour of a lender providing the requisite perfection by control. These control agreements, which stipulate that no securities may be withdrawn from the pledged account without express authorisation of a lender, are typically instituted at closing and provide for immediate control. Unlike other financings that may allow for shifting control (i.e., whereby control shifts from a borrower to a lender upon the occurrence of certain trigger events), margin loan financings often give a lender control over the relevant securities account for the entire life of the financing.

Sometimes the pledged securities are not in DTC form prior to financing and, while there are certain avenues available to deposit securities into DTC, not all securities are so eligible.[2] Often securities that are not in DTC are in "book-entry" form on the books of the issuer of the relevant securities (the "**Issuer**") or its transfer agent. Practically, this means that there is an entry for each record owner on the ownership books for such Issuer, setting forth the number and type of securities owned by each holder. In this scenario, control can be effected by negotiating for a contractual control arrangement with the relevant Issuer to satisfy the perfection requirement. In this scenario, the foreclosure outlook for book-entry securities is less straightforward than foreclosure on freely tradeable DTC securities because of this additional need to coordinate with the Issuer and/or its transfer agent, as applicable.

A third type of collateral involves securities that are certificated and then delivered to a lender or collateral agent for physical control. While this provides the same level of protection under the Uniform Commercial Code as DTC securities and book-entry securities in terms of perfection and priority, the foreclosure path becomes more complicated when physical delivery is required. To exercise remedies, a lender or collateral agent would have to present the physical certificates to the relevant Issuer or its transfer agent along with executed stock powers in order to effect a transfer.

SPV borrowers

Margin loan financings customarily require that the borrower be a newly created special purpose vehicle (an "**SPV**") with customary bankruptcy remoteness characteristics, which include restrictive purpose limitations in its organisational documents as well as the appointment of an independent director on the board of the SPV borrower whose consent is required for the SPV borrower to commence or consent to a bankruptcy filing. Typically, the independent director is provided by a third-party agency and will have no information and voting rights (and will not attend board meetings) in the context of a corporate decision in connection with a bankruptcy filing. Therefore, while an independent director does not make a bankruptcy filing impossible, it does impose important guardrails from the lenders' perspective.

Bankruptcy remoteness and the accompanying analysis of a margin loan financing as a type of "securities contract" that would benefit from certain safe harbour provisions of the United States Bankruptcy Code are a particular focus for margin loan lenders as they evaluate potential downside scenarios – including a safe harbour from the automatic stays in a U.S. bankruptcy that would otherwise prevent the lenders from immediately exercising remedies against the margin loan collateral. The threat of substantive consolidation in the event of a bankruptcy of the parent of any margin loan borrower is also an important consideration in these transactions. If the borrower and its parent are substantively consolidated (i.e., the assets and liabilities of the two are combined), the lenders' recovery could be delayed or diluted. By structuring margin loan borrowers to be bankruptcy remote, this risk is mitigated because substantive consolidation is less likely as between a debtor (parent) and non-debtor (borrower) entity.

Regulation U and other regulatory considerations

Margin loan financings extended by U.S. banking institutions and certain U.S. non-bank lenders, as well as loans made to U.S. persons and companies controlled by U.S. persons, operate under the regulatory overlay of Regulation U. Regulation U, which, together with Regulations T and X, represents the margin regulations promulgated by the Federal Reserve Board, limits the amount of "purpose credit" (i.e., credit extended for the purpose of buying or carrying margin stock) that can be extended in a financing that is directly or indirectly secured by margin stock. Regulation U requires any "purpose credit" secured directly or indirectly by margin stock to be fully collateralised, except that any margin stock collateral securing the credit is subject to a 50% haircut. By way of simple example, a borrower who seeks $100 million of "purpose credit" financing must pledge at least $200 million of collateral securities in order to meet the Regulation U requirement.[3] The analysis of whether Regulation U applies to any given margin loan financing depends upon whether a credit meets the definition of "purpose credit" and whether it is "directly or indirectly secured by margin stock" for purposes of Regulation U.

Under Regulation U, "margin stock" is defined to include equity securities registered on a national securities exchange, over-the-counter securities trading on a national market system, warrants or similar instruments related to the subscription or purchase of margin stock, certain American Depositary Receipts ("**ADRs**"), any debt security that is convertible into margin stock or any security issued by a registered investment company under the Investment Company Act of 1940 (the "**1940 Act**") (with certain exceptions). The scope of "purpose credit" is not limited to the immediate use of the proceeds of a margin loan – that is to say, if a margin loan is used to refinance another loan that was used to acquire the relevant "margin stock", then the margin loan financing is also deemed to be "purpose

credit". As such, any margin loan used to repay, for example, a borrowing at the relevant Fund by way of a refinancing would still be subject to Regulation U and its 50% test in the same way that such margin loan borrower would have been subject thereto if it were using the proceeds to acquire the "margin stock" itself. The term "directly or indirectly secured by margin stock" also has a broad meaning under Regulation U and can include negative pledges and other contractual arrangements that limit the ability of the borrower to sell or transfer margin stock.

It is also important to note that Regulation U is tested not only at initial incurrence of a margin loan, but at each subsequent extension of additional loans as well as each withdrawal or substitution of collateral.[4] For that reason, it is essential for any potential margin loan borrower to consult its counsel to discuss the various scenarios in which Regulation U may be a limiting factor while a margin loan financing is outstanding.

Issuer Agreement

Often margin loan lenders will require that the Issuer of the pledged collateral acknowledge and agree to certain matters related to the margin loan financing (an "**Issuer Agreement**"), which can include certain agreements and obligations relating to the procedure for effective transfers of securities or the conversion thereof, as applicable, on enforcement. The Issuer also customarily agrees not to hinder or delay any exercise of remedies by the lender upon a foreclosure. In addition to putting the Issuer on notice of the margin loan financing, the Issuer Agreement also serves to put the lender in privity with the Issuer with respect to those limited undertakings, offering an added element of comfort for lenders in the event of a foreclosure.

Benefits of margin loan financings for private fund sponsors

Non-recourse financing

One of the reasons margin loan financings are popular with private fund sponsors is that they are generally structured to be non-recourse to the relevant Fund entities that beneficially own the investment. In the majority of margin loan financings, the borrower is a newly formed SPV whose sole corporate purpose is to own the relevant investment and borrow under the facility. To the extent a margin loan borrower defaults, a lender's remedies under the facility, with few exceptions, are limited to the collateral itself (i.e., the pledged investment) and there is no contractual recourse to the relevant Fund for any deficiency.[5] The non-recourse nature of margin loan facilities enables a Fund to effectively isolate leverage at an SPV, which can be helpful for debt management at the Fund level.

Recapitalisation

Private fund sponsors look to margin loans and similar backleverage products for a variety of reasons that are similar to the motivations that drive borrowers generally, including as a tool to generally increase liquidity or to accelerate a return of capital to investors. For example, a Fund may employ an IPO as an exit strategy with respect to a portfolio investment, yet continue to hold significant amounts of publicly traded securities because it cannot fully dispose of its investment at the initial offering as the market cannot absorb such a large disposition. These securities can serve as collateral for a margin loan, the proceeds of which are distributed to the Fund's investors, thereby providing a return on the investment in advance of any actual disposition thereof while also allowing the investors to capture the upside of subsequent share price increases.

Refinancing and acquisition financing

Another common reason private fund sponsors look to margin loans is to finance the acquisition of the investment that is ultimately pledged thereunder – whether as a financing source at closing of the purchase or as a refinancing tool following the relevant acquisition. In a typical refinancing example, a Fund may call capital from its investors or borrow on a Fund-level credit facility to complete the acquisition of an investment and then refinance that with a margin loan facility. If refinancing a capital contribution, the borrowings under a margin loan facility would be used to return capital commitments to the Fund's investors within a certain time frame that would allow the Fund to "recycle" the contributions, effectively treating such capital contributions as if they had never been called. From a cash management standpoint, this moves the "cost" of the acquisition from the pool of capital commitments to a more efficient leverage platform, freeing up further uncalled capital commitments for other investments of the Fund. This utilisation method is of course dependent on the provisions in a Fund's governing documents that would allow for this type of recycling, and is not universal amongst fund sponsors. Refinancing a borrowing originally incurred under a Fund-level credit facility often achieves a similar purpose – freeing up further liquidity at the Fund level for other investments by moving the financing down from the Fund into the subsidiary SPV borrower level.

Using proceeds from a margin loan facility to acquire the relevant investment itself is also a possibility, albeit a more complex one than the options previously mentioned as the question of certainty of funds unfolds with some unique characteristics under a margin loan. While it is possible to get committed financing with fairly strict conditionality features, the inherently fluctuating value of the underlying collateral (at least with respect to publicly traded securities) in a margin loan financing means that the LTV percentage as of the signing date of the commitment could be substantially different than the LTV percentage as of the actual funding date of the margin loan. By way of example, fluctuations in the underlying collateral value could result in the unintended consequence of triggering a margin call immediately upon funding, due to circumstances that were unforeseen when the commitment was originally negotiated. Furthermore, there could be unexpected events that occur between signing and closing that lenders are unwilling to waive or overlook, making financing certainty even more precarious. As such, the use of margin loan facilities as a source of funding for an acquisition at the closing of the relevant underlying transaction is possible but not as common as the refinancing option.

Ultimately, the use of margin loans by private fund sponsors is a choice that is made after careful consideration of the relevant circumstances and a thorough cost-benefit analysis on the undertaking. There are additional key considerations from a Fund structure perspective (e.g., co-investment and tax structuring), as well as considerations under regulatory regimes such as the 1940 Act and the Employee Retirement Income Security Act of 1974, that any Fund should be aware of before embarking on a margin loan financing and about which it should consult its respective counsel.

Key mechanical elements of a margin loan facility

Basic covenants and reporting

Generally, margin loan facilities are light by way of covenants due to the SPV nature of their borrowers. Margin loan borrowers by design have very limited purpose provisions and so would not customarily take any actions beyond those related or incidental to its ownership of the collateral and its obligations under the relevant margin loan financing. Similarly, margin

loan lenders do not typically require robust financial reporting at the SPV borrower level other than customary compliance certificates from time to time (often on a quarterly basis).

In addition to the typical negative debt and negative pledge covenants commonly associated with SPV financing, margin loan facilities also typically include an additional negative pledge applicable to affiliates of the SPV borrower. Sometimes called the "*Future Financing*" or "*Restricted Transactions*" covenant, the purpose of this covenant is to prohibit affiliates of the SPV borrower (i.e., the Fund and its affiliated vehicles) from pledging any securities of the same class as those pledged under the relevant margin loan financing to secure alternative financing. This is aimed at preventing the relevant private fund sponsor from acquiring multiple margin loans on the same security and the potential overhang effect that might have. While it reaches beyond the borrower SPV, the Future Financing/Restricted Transactions covenant has been generally accepted as an element of margin loan financings.

Margin calls and cures

As discussed above in the section entitled "*LTV*", the occurrence of a margin call requires a corresponding cure to reduce LTV to the relevant Reset LTV level. This cure can take a few different forms, including a repayment of outstanding obligations (effectively reducing the numerator in the LTV calculation) and/or posting additional collateral to the lenders (effectively increasing the denominator in the LTV calculation). This cure is required to be made within a couple of business days, which is generally consistent across facilities in the market. One interesting point to note, which is perhaps unsurprising: lenders are generally reluctant to accept additional pledged securities as a margin loan cure method.

Generally, the margin loan borrower itself is unlikely to have cash on hand to effect such a cure, as its only source of cash would be distributions on the collateral or sale thereof and it would be uncommon for a Fund to leave substantial amounts of cash at the SPV borrower level. The SPV borrower similarly has no access to alternative leverage in order to borrow cash to make such a cure. As such, a cash cure, outside of a sale scenario, is likely coming from its respective Fund parent. Similarly, it is also possible that such Fund parent would not have cash readily available to contribute to the SPV borrower on such a quick timeline. For these occasions, some margin loan borrowers have requested an additional cure right to allow the Fund to call capital from its investors for the amount needed for such a cure (the "**Capital Call Cure Right**" and such required amount, the "**Cure Amount**"). A Capital Call Cure Right involves the Fund parent delivering a package of materials to the lenders, which may include a confirmation that such Fund parent has indeed called capital for the relevant Cure Amount, an equity commitment letter from the Fund parent in which it commits to transfer the proceeds of such capital call to the SPV borrower immediately upon receipt, and certain other customary representations and warranties. If delivered, the cure period is then extended to a date that gives the Fund parent enough time to receive the relevant capital contributions from its investors and contribute those amounts to the SPV borrower so that it may cure the relevant margin call (such extended period, the "**Capital Call Period**"). Effectively, it operates as a standstill for that Capital Call Period, with certain limitations; for example, upon receipt of notice by a Fund parent that any limited partner does not intend to meet its respective capital call, this standstill will automatically expire and the lenders may exercise their foreclosure remedies under the margin loan agreement if the relevant Cure Amount is not received immediately.

The inclusion of a Capital Call Cure Right option is by no means guaranteed for all private fund sponsors embarking on margin loan financing. Because it requires the relevant lender

to forestall any exercise of remedies for the full Capital Call Period, such lender views the utilisation of this cure right as taking credit risk on the Fund parent. Whereas the margin loan financing might otherwise have been non-recourse to the Fund, the exercise of a Capital Call Cure Right would, for that Capital Call Period, give a margin loan lender recourse to the relevant Fund parent for the required Cure Amount. In order for a lender to be comfortable offering a Capital Call Cure Right in any margin loan financing, such lender would need to diligence the relevant Fund parent to complete its own risk analysis.

In addition to using a Capital Call Cure Right, a Fund parent may also avail itself of its own Fund-level credit facility and leverage options to borrow the relevant Cure Amount and contribute it down to the SPV borrower to make the required payments. Comparatively, this would be a faster method of generating the liquidity needed and, from a practical perspective, likely to produce more certainty than issuing capital calls to investors and relying on their timely transfer of funds.

One last avenue of cash generation is to sell collateral, though this is understandably the least popular option. Putting aside the basic value reasons why a disposition to meet a margin call would not be palatable to a borrower, there are other considerations a holder of securities would have to contend with upon a sale, including for certain private fund sponsors that are considered "affiliates" of the Issuer under the Securities Exchange Act of 1934 (the "**Securities Act**"), that such margin loan borrower not have material non-public information when conducting such a disposition.[6]

Mandatory prepayments

In addition to the cure required in connection with a margin call, margin loan agreements also include a subset of other "mandatory prepayment events" ("**MPEs**") that trigger a repayment of all outstanding obligations and a termination of the facility. These events are typically viewed as events that, more or less, transform the underlying assumptions on which a margin loan financing was originally extended and thus warrant a full repayment. Commonly accepted triggers include insolvency of the Issuer, change of control of the borrower (typically as the relevant private fund sponsor ceasing to beneficially own or control such borrower), delisting of the relevant pledged securities, or a trading suspension that continues beyond a certain number of trading days and nationalisation of the Issuer.

Another customary MPE is what is known as a "stock price trigger", whereby the price-per-share of the relevant security falls by a substantial percentage as compared to the price-per-share thereof on the date of closing of the margin loan financing (a "**Stock Price Trigger MPE**"). Conceptually, a stock price trigger results in the same mathematical consequence as a margin call (i.e., the decline in the per-share price reduces collateral value, thereby increasing the LTV); however, the margin call LTV mechanics do not forestall the need for an independent Stock Price Trigger MPE from a lender's perspective. Rather, the Stock Price Trigger MPE is meant to be an individual lever on the financing: even if there is no margin call otherwise (perhaps because the borrower has made voluntary prepayments of the loan over time without depleting collateral, thereby maintaining a relatively low LTV), the drastic drop in the trading price of a security that a Stock Price Trigger MPE measures is meant to be a separate indicator of forthcoming risk for a lender. At a per-share price that is less than half of the original per-share price at closing, for example, a financing can be said to have fundamentally changed, as have the expectations of the lenders who extended it. Accordingly, the Stock Price Trigger MPE has been traditionally accepted as a trigger independent of margin call mechanics.

Other than MPEs and the mandatory prepayments implicated by margin calls, there are typically no additional amortisations on margin loan facilities, which is in line with the underlying SPV nature of the borrowers thereunder, who have no direct sources of liquidity other than via the proceeds from the pledged securities. The underlying assumption is that, all else being equal, margin loan financings are meant to cohabitate with a sponsor's divestment decisions with respect to the relevant investment, not dictate them. As such, the customary required prepayments under a margin loan agreement are tied to receipts of cash by the borrower, either through a distribution on the pledged securities or through a sale thereof. The quantum of these payments is generally tied to *pro forma* LTV tests, but can also be structured to be a payment of accrued interest to date or even a full cash sweep in some instances.

Facility adjustment events

Another subset of trigger events in most margin loan financings are those that qualify as "facility adjustment events" ("**FAEs**"), following which a lender is able to make adjustments to the facility to put itself in a similar economic position as it would have been had the relevant FAE not occurred. The mechanics associated with FAEs are adopted from the corresponding "potential adjustment event" in the 2002 ISDA Equity Derivatives Definitions and generally track the ISDA model, with appropriate modifications.

In addition to basic anti-dilution events such as stock splits, examples of customary FAEs include a change of control of the Issuer, tender offers with respect to the pledged securities, extraordinary distributions thereon and other events affecting share liquidity. Generally, a margin loan agreement will specify that, upon the occurrence of an FAE, the lender shall, in good faith, determine a set of adjustments to the facility that it believes in good faith would be warranted to restore its economic footing in the facility. The borrower has the right to accept such adjustments or, if not, repay outstanding obligations and terminate the facility.

In some instances, it is possible that a lender will determine that no commercially reasonable adjustment is possible following an FAE, in which case a mandatory prepayment on the entire facility is triggered and the facility will then terminate. While sometimes similar in nature, FAEs differ conceptually from MPEs in the sense that they are events that likely have an impact on the trading characteristics of the security – and, transitively, any financing secured thereon – but unlike MPEs, not all FAEs are expected to have a negative impact on the collateral or, even if such a negative impact is expected, not to the extent that a full mandatory prepayment and termination of the facility is automatically warranted.

Collateral releases

The predominant collateral release associated with a margin loan is a release of securities for a pending sale. Logistically, this requires a certain amount of coordination with the custodian or collateral agent in control or possession of the relevant securities. In a routine sale of DTC securities, this generally means coordination of the transfer of securities to the buyer's brokerage account against cash proceeds received from the relevant collateral accounts. However, depending on the nature of the pledged security, the sale can become more complicated – for example, if the securities are in book-entry form, then coordination is needed with the Issuer or its transfer agent, as applicable, and any physical certificates would require coordination to recut certificates to account for partial sales. Generally, lenders under margin loan financings are aware of the various logistical hurdles required to effect such a release and, given that financings are often repaid at least in part with the proceeds of such dispositions in order to satisfy relevant LTV release tests, the interests of the borrower and its lender are generally aligned in this endeavour.

Other than a sale, releases of collateral are generally reserved for cash or other types of cash equivalents (e.g., treasuries) that may be held in the collateral accounts from time to time. Such releases usually involve a *pro forma* LTV test at an agreed-upon level and a certain amount of prior notice to the collateral agent or custodian is required. Typically, margin loan financings do not allow for the release of share collateral absent a sale because, as previously mentioned, share releases are often associated with dispositions that are cash realisation events that lenders share in to some degree, depending on the terms of the financing.

Conclusion

Even as certain elements of margin loan facilities have become well established in this unique marketplace over the last decade, the product itself is constantly evolving and private fund sponsors and their partner banking institutions are always finding new and innovate ways to employ margin loans and related backleverage products. Any borrower seeking to transact in this space should consult with its counsel to understand all of the structuring and other implications of such a facility.

* * *

Endnotes

1. While there may be some variations on the calculation method across different facilities, we will use this basic equation for purposes of discussing LTV in this chapter.
2. This process is complex and involves several intricacies of securities laws that are best discussed with one's counsel.
3. The loan would also comply with Regulation U if the borrower seeking $100 million of "purpose credit" pledged $50 million of real estate collateral and $100 million of margin stock collateral, because only the margin stock collateral is subject to the 50% haircut.
4. There are also complicated rules for testing Regulation U compliance for revolving facilities.
5. Alternatively, credit support from a Fund can be used to mitigate risk from a lender's perspective and achieve better pricing or to facilitate a facility on unique or particularly illiquid collateral, such as private company interests.
6. For a more nuanced analysis of the Securities Act and how it affects dispositions of securities, each margin loan borrower should discuss with counsel.

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