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STRUCTURING DIRECT LENDING FUNDS

STRUCTURING DIRECT LENDING FUNDS

Open-Ended vs. Closed-End Structures; U.S. Tax Considerations; and Recurring Regulatory, Valuation, and ERISA Considerations

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Agenda

I. Relevance of Direct Fund Lending

II. Structuring Overall in Fund Lending Businesses

III. Open End vs. Closed End Structuring

IV. U.S. Tax Considerations

V. Regulatory Issues Relevant to Direct Lending Funds

VI. ERISA Considerations

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RELEVANCE OF DIRECT FUND LENDING

Relevance of Direct Fund Lending

Current Investment and Lending Climate – Demand for Nontraditional Lenders

- **Since 2008, the Perfect Storm:**
  a. Cyclical markets
  b. Banks constrained by regulatory/capital requirements
  c. Investors needing real income
     i. Low interest rate environment
     ii. Individual retirees in particular need of income
- **Popular Versions:**
  - Real estate finance (sub-themes like commercial, MFH, vacation income properties, etc.)
  - Corporate lending
  - Entertainment finance
  - Health care finance

Relevance of Direct Fund Lending

Current Investment and Lending Climate – Demand for Nontraditional Lenders

- **Explosion of Product**
  - Clients launching funds “deeper” into investment sectors
    - Middle market and consumer lending
  - Clients saying too much competition
  - Nevertheless, regional players thriving

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STRUCTURING OVERALL IN FUND LENDING BUSINESSES

Overall Structuring in Fund Lending Businesses

- **Clients coming to establish new funds are very often already in the lending business**
  - Lending on their own balance sheet
  - Originators for other lenders
  - “Refugees” from I-Banks and other lenders
- **Accordingly, structure advice often begins with where asset management business fits into the overall business**
- **What area “other” businesses?**
  - Origination of Loans
    - In the future “co-investment”
  - Servicing of loans
  - Lending from principal balance sheet
- **Conflicts between these business lines**
  - Will be discussed further below

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Sample Management Structure for Lending Businesses

Principals

Asset Management

Servicing

Principal Lending

Origination

OPEN END VS. CLOSED END STRUCTURING

Open End vs. Closed End Structuring

Alternative Structures

1. Open End Fund Characteristics

- It looks like a mutual fund
- Designed to last for an indeterminate time into the future
- No specific term for it to close
- Investors accepted and withdraw at specific, periodic times (monthly, quarterly, annually, etc.)
- This requires a mechanism to value the portfolio whenever investors come join
- Mechanism is also required to value the portfolio whenever investors withdraw

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Open End vs. Closed End Structuring

Alternative Structures

2. Closed End Fund Characteristics

- It is often referred to in the jargon of professionals and industry managers as "PE fund"
- Designed to last only for pre-determine time into the future
- Investors often make commitments rather than make immediate investments
- Specific periods identified in advance of the fund:
  - <u>Closing period:</u> period until which the fund may accept new commitments
  - <u>Capital commitment call period:</u> period until which the fund may call capital from investors who commit capital
  - <u>Investment period:</u> period until which the fund may make new investments
  - <u>Investment "harvest" period:</u> period until which the fund can hold the assets before they must be sold

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Open End vs. Closed End Structuring

Alternative Structures

2. Closed End Fund Characteristics

- Investors generally may not withdraw at any time
- This means that NAVs will generally not be required for purposes of new and withdrawing investors
- NAVs will generally required for GAAP and other reporting purposes, but not economic terms of the fund
- Sometimes NAVs will required for certain other economic terms of the fund:
    - Limited adjustments to new investor investments (based on NAVs)
    - Limited withdrawals
    - Capital write-offs (for waterfalls)
    - Calculations of management fees

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Open End vs. Closed End Structuring

Alternative Structures

3. Comparison of Such Structures:

- From most legal and operational perspectives, the closed end structure is preferable
- Key advantages of closed end: fund economic terms not determined by NAVs
  - SEC doesn't like these funds
  - Regulator and investor concerns about such structures: unreliability of NAVs
  - Fraud and other malfeasance have dogged these assets in these structure
    - Performance and management fees set to AUM in open ended fund
    - Conflicts have proved irresistible many times, historically (e.g., when fund is having problems)
  - **Some auditing firms will not audit an open end fund with illiquid assets**
    - Others set expansive requirements for valuation agents and methodologies
    - It will likely be **expensive** to deal with valuation

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Open End vs. Closed End Structuring

Alternative Structures

3. Comparison of Such Structures:

- Operational advantages:
    - NAVs are just hard to strike
    - Under GAAP is not always crystal clear
    - Legal risks make auditors and others fearful and more demanding of the process

- Selling assets for withdrawals:
    - Illiquid assets are hard to sell

Open End vs. Closed End Structuring

Alternative Structures

3. Comparison of Such Structures:

- Key advantage open end fund advantage is **typically only one:**
    - **Liquidity at times is an absolutely essential term to interest the investor pool in the fund**
        - Particularly for retail and family office investors, the need for some liquidity can be absolutely critical to signing up an investors
        - **Beware of illusion of liquidity**
        - **Particularly important for those of you reviewing a fund for an investor** (e.g., quarterly liquidity except for the fine print)

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Open End vs. Closed End Structuring

Alternative Structures

4. Adaptions to Open End Structure: Hybrid Structure:

When: if marketing advantages of open ended structures are irresistible
Adaptation: Timing of Liquidity

- Long initial lockups
  - 2-3 years (co-terminus with maturity of many products)
  - Exaggerated examples: life settlement fund we are working on now with 10 year initial lockup
- Problem with long initial lockups:
  - Simply puts off the day of reckoning
  - How does one satisfy a wave of withdrawals a few years from now?

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Open End vs. Closed End Structuring

Alternative Structures

4. Adaptions to Open End Structure: Hybrid Structure:

When: if marketing advantages of open ended structures are irresistible
Adaptation: Timing of Liquidity

- Other classic tactics:
  - Frequency of withdrawal (irrespective of lockups)
  - Notice Periods
  - Gates
  - Side pockets
- However: marketing challenge
  - Side pockets in particular are very unpopular
  - Infrequent withdrawal periods also unpopular

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Open End vs. Closed End Structuring

Alternative Structures

4. Adaptions to Open End Structure: Hybrid Structure:

When: if marketing advantages of open ended structures are irresistible
Adaptation: Timing of Liquidity

- More complicated barriers to withdrawal:
  - Instead of only initial lockup, also impose "rolling lockup“ e.g., only withdraw every 2-3 years
  - Different flavors: sometimes anniversary of particular investment by investors
  - Sometimes a single withdrawal opportunity for everyone every 2-3 years

- Adaptation: Funding of Liquidity
  - Payment of withdrawal subject entirely to availability of capital to pay it off
  - Payment of withdrawal subject entirely to subsequent sale of portfolio investments and having relevant proceeds available from it

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Open End vs. Closed End Structuring

Alternative Structures

5. Adaptions to Open End Structure: Hybrid Structure:

When: if marketing advantages of open ended structures are irresistible
Adaptation: Timing of Liquidity

- Newer strategies
    - Length of Payout periods
    - Novel Payout calculations (e.g., disassociate from NAV?)

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Open End vs. Closed End Structuring

Emergence of Registered Interval Funds

- Becoming popular with other illiquid asset classes
  - VC
  - PE
- Becoming popular with other illiquid asset classes
- Remains to be seen whether it realistically solves anything
  - In theory creates liquidity PE
  - But it turns out to have some of the same issues as private open ended funds
  - Rumors of gates being implemented etc.

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U.S. TAX CONSIDERATIONS

U.S. Tax Considerations

General U.S. Tax Considerations

- Different Investor Classes –Different Tax Considerations
- U.S. Taxable/Tax-Exempt, Non-U.S. Investors
- “Trade or Business”
- Manager Level Issues

U.S. Tax Considerations

U.S. Tax-Exempt Investors

- Not Exempt on All Income
- Unrelated Business Taxable Income, or "UBTI"
- Exclusions from UBTI do not include debt-financed income

U.S. Tax Considerations

Non-U.S. Investors

- Subject to tax and return filing requirements if engaged in trade or business in United States
- Partners engaged in partnership’s trade or business
- “FDAP” income not connected with trade or business

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U.S. Tax Considerations

Tax Structuring –General Approaches

Non-U.S. (and possibly U.S. Tax-Exempt) Investors

- Possible strategies
- U.S. corporate taxpayer engaged in lending business
- Secondary market purchases of debt
- Reliance on income tax treaties

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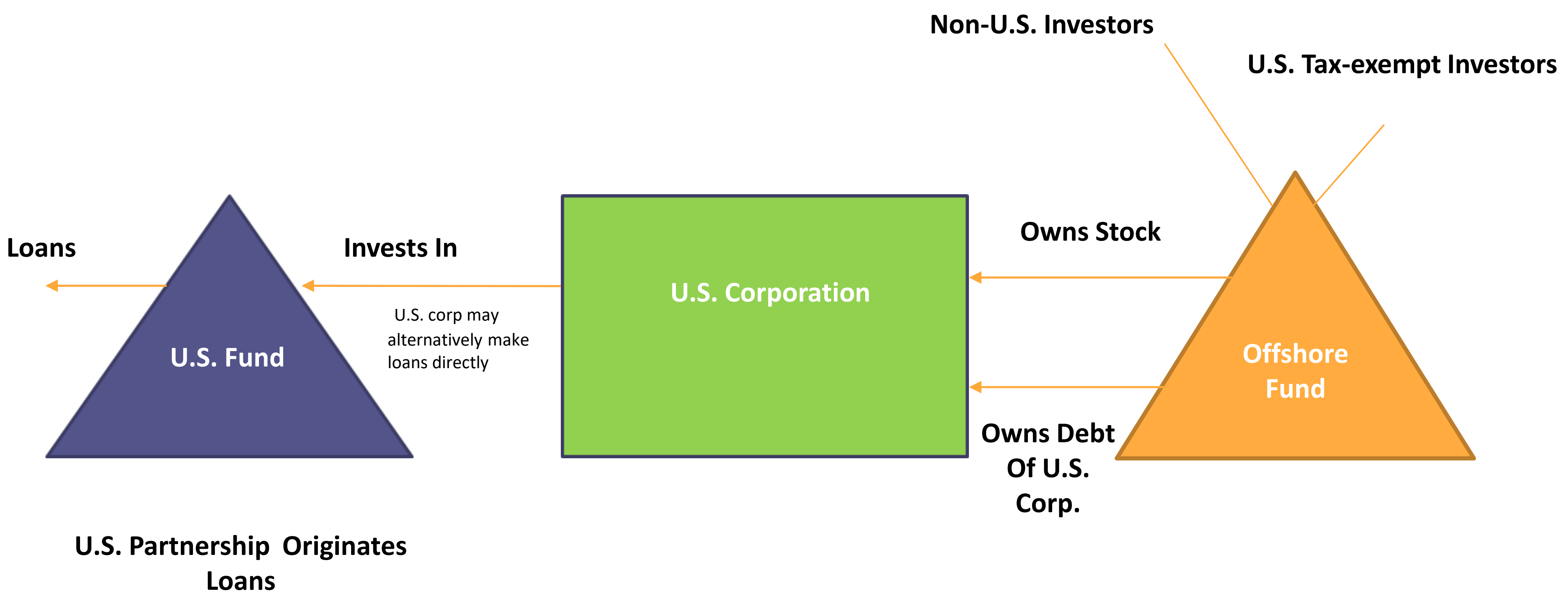
U.S. Tax Considerations: Sample Structure

U.S. Corporation, Issues Shareholder Debt



U.S. Tax Considerations: Sample Structure

Foreign Investment through U.S. Corporation

- U.S. Corporation subject to income tax
- FDAP withholding –dividends and non-”portfolio interest”
- Debt-equity considerations
- Portfolio Interest Rules
- Redemptions Treated as Dividends

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U.S. Tax Considerations: Sample Structure

Closed-end Regulated Investment Company Structure

Loans

U.S. Corporation
(RIC)

Dividends –exempt from U.S. withholding tax to the extent they are "Interest-Related Dividends"

Shareholders are:

- U.S. Persons
- Non-U.S. Persons
- U.S. Tax-Exempt Entities

Elects RIC Status

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U.S. Tax Considerations: Sample Structure

Closed-end Regulated Investment Company Structure

- Many technical requirements
- Expensive and complex to establish and maintain
- Potentially versatile within inherent restraints

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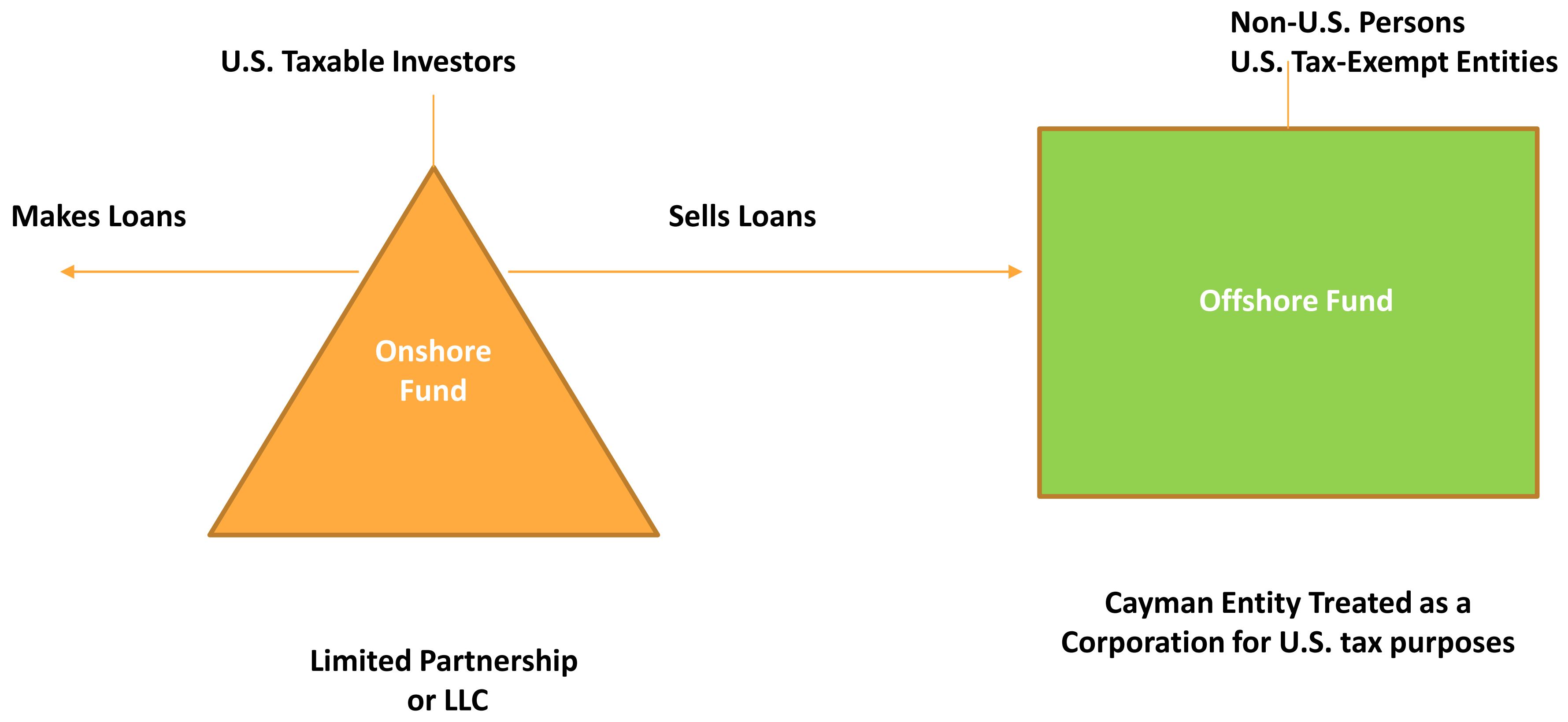
U.S. Tax Considerations: Sample Structure

Seasoning Strategy



U.S. Tax Considerations: Sample Structure

Seasoning Strategy

- Many misconceptions –not simply “wait X days before an interfund transfer”
- Relies on lack of “agency” relationship
- “Agency” relationship determined under tax law
- Very fact specific, limited legal authority
- Operational implementation crucial

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U.S. Tax Considerations: Sample Structure

Strategies Utilizing Income Tax Treaties

- Treaty-Based Structures
- Fund in Treaty Jurisdiction (such as Ireland, Luxembourg)
- “Bring your own treaty” or “BYOT”

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REGULATORY ISSUES RELEVANT TO DIRECT LENDING FUNDS

Regulatory Issues Relevant to Direct Lending Funds

Conflicts, Transaction Fees; Other Regulatory Issues

- SEC and Institutional focus on these conflicts
- Emphasis on giving the limited partnership advisory committee (“LPAC”) approval rights over affiliate transactions
  - Independent valuation of sale from originating vehicle (onshore) to offshore investment vehicle. Who pays?
- Requiring GPs to disclose all transaction fees and services provided by affiliates
  - Affiliates of the GP earning a servicing fee or an origination fee needs to be disclosed with specificity
- Pressure from LPs to eliminate GP share of transaction/monitoring fees
- SEC concerns include transparency (full, fair and timely disclosure to investors)

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Regulatory Issues Relevant to Direct Lending Funds

Investment Company Act

- Need for exemption under ICA
- Often overlooked because vehicle is not a “blind pool”(conventionally thought of as a fund)
- Classic Exemptions of 3(c)(1), 3(c)(5), 3(c)(7) would be most relevant
- Increased possibility of availability of 3(c)(5)
    - Mortgages and other forms of real estate debt
    - Asset Composition Test

Regulatory Issues Relevant to Direct Lending Funds

Investment Adviser Registration – Who is Required to Register?

- Investment advisers that manage between $100 million and $150 million in assets that manage one (1) or more managed accounts must register with the SEC
- Investment adviser that manage less than $100 million in assets generally must defer to the relevant investment adviser statutes in the state(s) where they conduct business
- Investment advisers that can rely on the Private Funds Adviser Exemption may still need to become an Exempt Reporting Adviser with the SEC
  - Funds only
  - Less than $150 mm in AUM
- Investment advisers must include all gross assets (including leveraged amounts) in calculation assets under management
- Investment advisers to private equity funds must include uncalled capital commitments (not just drawn down capital) in calculating assets under management

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ERISA CONSIDERATIONS

ERISA Considerations Relating to Private Investment Funds

1. Plan Assets Issues; Fiduciary Status and Prohibited Transaction Issues

If the assets of an entity (e.g., a corporation, partnership or trust) are treated as plan assets of a benefit plan investor that owns an equity interest in such entity, the parties having management authority over the assets of such entity would be treated as fiduciaries under ERISA with respect to such plan investors. In addition, transactions entered into by such plan asset entities would be subject to ERISA scrutiny including complex prohibited transaction rules.

A. General Rules on Plan Assets Status

Under the ERISA plan assets regulations, the assets of an entity in which a plan has an **equity interest** will **not** be treated as plan assets if the equity interests are(1) **publicly traded securities or (2) a security issued by an investment company registered under the Investment Company Act of 1940.**

ERISA Considerations Relating to Private Investment Funds

In all other cases the assets of the entity will be treated as plan assets for ERISA purposes unless:

(1) the entity qualifies as an "**operating company**" which term also includes a "**venture capital operating company**" or a "**real estate operating company**"; **or**

(2) **the aggregate investment in the equity interests of the entity that are owned by "benefit plan investors" is less than 25 percent of the outstanding equity interests in such entity (the Insignificant Plan Investment Exception").**

An equity interest is defined as any interest in an entity other than an interest that is treated as indebtedness under local law and has "no substantial equity features".

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ERISA CONSIDERATIONS

ERISA Considerations Relating to Private Investment Funds

B. Operating Company Definition

An operating company is defined as an entity that is **“primarily engaged, directly or through a majority owned subsidiary or subsidiaries, in the production or sale of a product or service other than the investment of capital.”**

(1) Start-up Ventures and Companies Engaged Solely in Research and Development May not Qualify under this Definition.

(2) The Venture Capital Operating Company **(“VCOC”)** and Real Estate Operating Company **(“REOC”)** Exemptions Were Added Later.

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ERISA Considerations Relating to Private Investment Funds

VCOC Definition

To qualify as a VCOC, the entity must satisfy two requirements: First, at least 50 percent of the entity's assets (at cost) must be invested in "**venture capital investments**" or "derivative investments" as defined. Second, the entity must obtain and exercise "management rights" with respect to at least one of its operating company investments. **The term "venture capital investment" is defined as an investment in an "operating company" in which the investing entity has obtained management rights.**

REOC Definition

The REOC definition is similar to the VCOC definition. In order to be a REOC, the entity must: (1) have at least 50 percent of its assets (valued at cost) "invested in **real estate that is managed or developed** and with respect to which such entity has obtained the right to substantially participate directly in the management or development activities"; **and (2) be directly engaged in real estate management or development activities.**

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