Professional Perspective

Treatment of HNW Feeders in Subscription Secured Credit Facilities

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With up to 20% of new committed capital in private equity funds ("Funds") coming from retail investors—typically high net worth individuals—a percentage that is projected to grow, there is an increasing demand to include such investors in the borrowing bases of subscription secured credit facilities.

Historically, high net worth individuals, their estate planning vehicles and family offices (collectively, "HNW Individuals") have participated in Funds, but were often excluded from borrowing bases because the borrowing base mechanics, and the underlying risk assessments, were generally tailored to large institutional investors. Some lenders, however, are reconsidering this approach.

This article focuses on why HNW Individuals and aggregator vehicles that pool the subscriptions of HNW Individuals ("HNW Feeder") are becoming more attractive as investors in Funds, and the risks and issues lenders should consider when evaluating the creditworthiness of HNW Individuals and HNW Feeders.

Professional Perspective

Subscription secured credit facilities are revolving debt facilities ("Facility") provided by a lender to a Fund and secured by the capital commitments of investors, the right to call on such investors to fund their capital commitments and related enforcement rights. To determine what amount can be borrowed under the Facility, the lender and Fund create an agreed upon borrowing base.

A borrowing base is derived by multiplying the then-existing unfunded capital commitments of certain creditworthy investors by an advance rate—e.g., 90%, 65%, 50%, or a combination of rates. The resulting figure reduces over time as capital is called by the Fund to, among other things, repay debt, capitalize investments, and fund operating and investment related expenses. Investors that are rated or have other objective indicia of creditworthiness will receive the highest advance rate, e.g., 90%, as their perceived default risk is low. Investors lacking such objective criteria but whom the lender still deems generally creditworthy will receive a lower advance rate—e.g., 65% or lower—as such investor's perceived credit risk is higher but still sufficient for borrowing base inclusion. The remaining investors will often not receive any credit in the borrowing base.

Lenders often go one step further to protect themselves against risk by applying concentration limits to investors—based on investor classification—which may be on an individual and/or aggregate basis. Like advance rates, concentration limits further reduce the amount of an Investor's unfunded capital commitment for borrowing base purposes. This limits credit exposure to any one investor or class of investors and ensures greater relative diversification in the arranged borrowing base.

What Is a HNW Feeder?

As mentioned above, a HNW Feeder is a collective investment vehicle where the commitments of HNW Individuals are pooled. The HNW Feeder may be arranged by large, well-known institutions providing private wealth management services to high net worth clients ("PWM Sponsor"). The high net worth participants are typically understood to be individuals who have a minimum of $1 million of capital to invest—which aligns with the individual net worth threshold for an "accredited investor"—and, if the HNW Feeder is arranged by a PWM Sponsor, are established clients of the PWM Sponsor who satisfy favorable credit requirements of the PWM Sponsor.

These minimum requirements are often intended to protect retail investors and ensure that those who are investing have the capital and experience required to do so. While the "accreditation" threshold is high in terms of investible cash for an individual, the majority of Funds also have a minimum subscription—i.e., "buy-in"—threshold which is typically higher than the amount an HNW Individual may be able to invest in a single Fund. Therefore, in order to meet these minimum subscription thresholds of the Fund and invest alongside larger institutional investors, the subscriptions of HNW Individuals are pooled in an HNW Feeder, which in turn makes a more sizable and opportunistic investment.

While there are certainly individual investors capable of investing directly, through a structured investment vehicle or a family office type investment, this structure provides a broad group of HNW Individuals greater access to investment opportunities and strategies that they are not otherwise able to access on an individual basis, as well as more favorable collective bargaining power in any side letters entered into with the Fund.

The use of HNW Feeders allows Fund sponsors to tap into additional sources of high-quality capital which may otherwise be difficult to source or unavailable due to a Fund's minimum subscription threshold. Where an HNW Feeder is created and organized by a related PWM Sponsor, the Fund can access previously vetted HNW Individuals, thereby reducing the administrative burden on the Fund of soliciting, reviewing and subscribing individual HNW Individuals, while concurrently helping the PWM Sponsor meet return targets for its customers.

While this article focuses on the use and treatment of HNW Feeders in Facilities, it is worth noting that HNW Individuals may also invest directly in the Fund—not via an HNW Feeder—and the Fund may negotiate with the lender to include certain of these HNW Individuals in the borrowing base. In a commingled borrowing base of that nature, the percentage of HNW Individual commitments will often be a fraction of the overall Fund commitments. Given their relative value, applicable advance rates and concentration limits for individual investors will generally be quite low. Where a Fund has both HNW Individuals that are investing directly in the Fund as well as through an HNW Feeder, the Facility may include separate concentration limits applicable to (i) HNW Individuals, and (ii) the HNW Feeder. The concentration limit applied to HNW Individuals may be lower than that applied to the HNW Feeder (as the HNW Feeder is more diversified and therefore presents a lower risk).

In addition to the above, there are also Facilities where the entire—or vast majority—of the borrowing base is comprised of HNW Individuals—directly or through HNW Feeders. These Facilities are typically put in place for Funds arranged and sponsored by well-known financial institutions catering to high net worth and ultra-high net worth individuals. These HNW-focused Facilities include many of the considerations described throughout this article, but with a heightened sensitivity given the complete reliance on these smaller investors—many of which may be confidential at the outset of the transaction, as discussed further below. In such a situation, lenders may be willing to give borrowing base credit to all investors by applying a lower overall advance rate—e.g., 50%—against all unfunded capital commitments. Such flat-rate deals may require the lender to consider additional structuring and drafting modifications that are beyond the scope of this article.

Considerations When Lending Against HNW Feeders & HNW Individuals

Below are several items for lenders to consider when structuring a borrowing base with HNW Feeders and HNW Individuals. The approach a lender will take varies depending on a number of factors, including, primarily, whether the HNW Feeder was formed by a PWM Sponsor or by the Fund itself or if the direct collateral pool is predominately HNW Individuals.

Diligence

Novel & Onerous. The major obstacles to including HNW Feeders or HNW Individuals in a borrowing base relate to the credit assessment of, and direct accessibility to, the underlying investors. Credit assessments of pooled investments via a feeder structure are not unique to HNW Feeders in particular, as any vehicle aggregating the commitments of multiple investors faces the same issue of evidencing credit linkage through the vehicle to the underlying investors.

However, such information is harder to efficiently analyze for HNW Individuals as compared to government bodies or rated corporate investors or pension plans. Lenders with established platforms have general assessments available for the most active institutional investors. A PWM Sponsored HNW Feeder can help reduce such inefficiencies by having standard platform requirements that a lender can vet as a general matter, as compared to assessing each individual on an investor-by-investor basis.

Confidentiality. For Funds and HNW Feeders that have confidentiality concerns related to identifying information for individual retail investors—beyond confirmation that the investors fit the wealth management profile and/or fund all capital commitments with cash held by the sponsoring institution—identifying information about the HNW Individuals may be redacted, which prevents a lender from underwriting these individuals and would impede the ability to issue capital calls directly upon, and pursue remedies against, such investors.

If this situation is presented, one solution to satisfying both parties' concerns is to include a requirement that non-redacted investor documents be held pursuant to an escrow arrangement. See "Escrow Arrangements" under Documentation below for specifics.

Investor Documents. Where the HNW Feeder is a credit party, some lenders may require the same level of due diligence on the underlying investors in the HNW Feeder as they would against any other investor—excluding escrowed facilities discussed below—which includes reviewing their subscription agreements—or a certified, common form of subscription agreement—and any side letters—sometimes on a redacted basis.

In addition to confirming commitment amounts and notice details for issuing and enforcing capital calls, organizational documents are reviewed to determine if any restrictions or rights are included which could permit the HNW Feeder or its underlying investors to refuse to, or be excused from, meeting a capital call—e.g., excuse rights, transfer provisions, overcall limitations, etc.

In certain cases, depending on the language in the applicable governing agreements, lenders may enter into an investor letter with the HNW Feeder where it makes certain representations and warranties to the lender regarding its commitment and status of the underlying investors and agrees to provide additional information when requested.

KYC & AML. Regardless of whether the investors in an HNW Feeder are to be included in the borrowing base, a lender needs to be satisfied that appropriate "know your customer" ("KYC") diligence has been completed on all investors in order to meet its own regulatory and legal requirements.

Having a well-established PWM Sponsor organize the pool of investors in an HNW Feeder simplifies the KYC and underwriting process to the extent lenders are comfortable with the particular wealth management platform, the clients the platform attracts, the certifications made by such PWM Sponsor with respect to investor qualifications and pool characteristics, and the anti-money laundering ("AML") and KYC protocols.

For PWM Sponsored facilities, AML and KYC diligence may be satisfied by a number of certifications from the PWM Sponsor to the Fund or applicable lender confirming, among other things:

- That the individual investors are existing clients of the PWM Sponsor.
- The AML and KYC requirements applicable to the PWM Sponsor—which generally correspond to, or are consistent with, requirements imposed on lenders.
- The existing policies and procedures and due diligence conducted with respect to the individual investors to satisfy such AML and KYC regulations and policies—including with respect to beneficial owners.
- The existence of policies, procedures, and systems to detect and report suspicious activity and perform automatic monitoring and screening.
- Whether the PWM Sponsor has the authority to withdraw proceeds from the individual investor accounts with the PWM Sponsor to fund capital contributions.

Documentation

Escrow Arrangements. If there are PWM Sponsor concerns around revealing the identity of individual investors in an HNW Feeder or Fund, the parties may agree to an escrow arrangement pursuant to which an escrow agent—which may be a third party depositary—is appointed and the Fund agrees to deliver the investor documents applicable to HNW Individuals to said escrow agent.

The loan documents will stipulate that in the event of a default, the applicable investor information will be released to the lender from the escrow agent, thereby giving the lender sufficient information to issue capital calls. Assuming no event of default occurs, the escrow arrangement will be terminated with other loan documents upon satisfaction of facility obligations and the escrow agent will be instructed to release the investor documents back to the Fund.

Given the inability of the lender to diligence the underlying collateral, a strong, working relationship between the Fund and lender, and an intimate understanding of the high net worth platform of the PWM Sponsor and its strengths, protections and historical performance are key to considering such an escrow arrangement.

Pledging. For transactions where a particular HNW Feeder represents a significant portion of the overall investor commitments, a lender may require the right to issue and enforce capital calls on each of the underlying investors. This requires the HNW Feeder to pledge the underlying commitments and enforcement rights directly—or indirectly via a cascading security structure—to the lender under the loan documentation.

Most commonly this occurs when the HNW Feeder is related to the Fund sponsor, in which case documentation will generally track the agreed loan documentation and include delivery of security documents and various undertakings by the HNW Feeder. However, if the HNW Feeder is organized by an unrelated PWM Sponsor, documentation for the HNW Feeder may differ from that of the Fund parties to, and be tailored specifically to, the HNW Feeder and its PWM Sponsor—e.g., confidentiality of applicable investor information, delivery of subscription agreements, escrow arrangements, specific collateral account requirements, enforcement rights, etc.

If the Fund's investor pool is well diversified beyond the HNW Feeder, a lender may not push for similar, independent enforcement rights or require a high level of detailed credit diligence. In this scenario, an HNW Feeder may be treated the same as other Fund investors, both in terms of documentation delivery requirements—usually a subscription agreement and, if applicable, a side letter—and lender enforcement rights limited to calls on the HNW Feeder, as opposed to its underlying investors.

Reporting Requirements. While understanding the PWM Sponsor's client requirements provides a level of comfort with respect to the quality of the underlying investors, lenders will want additional visibility into, and diligence regarding, the composition of the investors in the HNW Feeder, and periodic updates from the PWM Sponsor regarding the specific pool of investors, including:

- The number of underlying investors.
- The average capital commitment.
- The median capital commitment.
- A list of investor capital commitments in excess of an agreed floor—i.e., lenders may want to know which investors have commitments of over a certain threshold if the average commitment is relatively low, since a lender may have outsized risk to the larger commitments.
- Any underlying investor capital contribution delinquency or default.
- KYC and AML compliance certifications.

Lenders are further comforted if the underlying investors fund capital directly from accounts held at, and, in some cases, subject to withdrawal authority maintained by, the PWM Sponsor.

Bespoke Provisions. When negotiating the loan documentation, certain provisions may be tailored to account for specific needs of HNW Individuals and PWM Sponsor. For example, many retail investors are interested in PWM Sponsors that offer liquidity via robust secondaries platforms and permitted transfers.

The restrictive covenant on investor transfers may be adjusted to permit quick transfers in or out of the HNW Feeder without any lender consent, so long as the transferee meets the requirements of the PWM Sponsor. Other Facilities may allow transfers without any restrictions —other than satisfying necessary documentation delivery and mandatory prepayment requirements—up to a certain percentage of the borrowing base each quarter or other specified period.

The covenants must be drafted to appropriately track how the HNW Feeder operates while also ensuring the lenders have accurate and timely reports on their collateral as they cannot lend using stale information. For a more comprehensive list of additional drafting considerations, see Checklist – Documenting Subscription Secured Credit Facilities With HNW Feeders.

Enforcement

Default Triggers. Another possible feature of Fund structures with an HNW Feeder is a bifurcation of default triggers and remedies. Should an HNW Feeder fall short when funding a particular capital contribution, side letters and organizational documents may contemplate a modified capital contribution enforcement procedure whereby the non-defaulting portion of the underlying individual investors—i.e., the "good investors"—are segregated from defaulting individual investors—i.e., the "bad investors"—and default remedies may be exercised against only the portion of the HNW Feeder's commitment attributable to the bad investors.

This may result in a partial forfeiture of interests and forced sale or facilitating secondary transfers—or substitutions with other clients of a PWM Sponsor, if applicable—with respect to the defaulting investor(s) to ensure that the HNW Feeder is able to make all required capital contributions and to not unfairly penalize the investors in the HNW Feeder meeting their required funding obligations.

Conclusion

It is possible for Fund sponsors to maximize the additional liquidity provided through HNW Feeders by seeking to include the underlying investors in its Facility borrowing base. The ability of a lender to do so will hinge on several factors, including its relationship with the sponsor, its understanding of the sponsor's diligence processes, and whether the additional risk associated with HNW Feeders is offset, in whole or in part, by more creditworthy institutional capital.

Sponsors seeking to obtain borrowing base credit for such investors should be conscious that additional diligence will likely be required and certain protective measures will be put in place to limit a lender's exposure to such investors.

