Fund Finance

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Derivatives at fund level

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Overview

This chapter considers a number of structural and documentary legal issues to be considered by a fund that is thinking about entering into derivative transactions at fund level. The observations made in this chapter are drawn from experience in the European fund finance and derivatives markets and are not tailored to any particular derivatives strategy.

This chapter does not provide detailed legal and regulatory analysis in relation to particular issues by reference to the laws of any particular jurisdiction. Any fund that intends to enter into derivatives at fund level should obtain legal and regulatory advice under the laws applicable to the proposed parties to the transaction and to the transaction itself, which should be tailored to the particular characteristics of the parties, the fund's constitutional documents and the circumstances of the transaction. The international nature of the funds and derivatives markets, and the growing tide of regulation in the derivatives space, means that increasingly this legal and regulatory advice will need to consider laws from multiple jurisdictions.

Introduction

There are a wide variety of reasons why a fund may consider entering into derivatives, but derivative use can generally be split between derivatives of a speculative nature used by a fund to target investment return, and derivatives of a hedging nature which are designed to protect against the economic impact of a particular risk faced by that fund.

Basic examples of risk that a fund may wish to mitigate with derivative use are foreign exchange (forex/FX) exposure (for example, covering the currency exposure for a USD fund that will be drawing USD amounts from investors to fund a particular investment that is denominated in GBP) and interest rate exposure (for example, covering the risk of an adverse movement in interest rates increasing the amount required to be paid on borrowings made by the fund). For some funds, FX and interest rate hedging will be all that the derivative strategy needs to cover. At the other end of the spectrum, funds that use derivatives in the active pursuit of investment return can be expected to enter into a wide array of sophisticated derivative instruments.

Sometimes a fund's exposure to a particular risk is indirect and it is more appropriate for the relevant derivative to be entered into below fund level. A common example in the private equity fund space is interest rate hedging for an acquisition finance facility. The buyer under the relevant acquisition transaction will be a vehicle set up by the fund to make the acquisition. It is this vehicle that would enter into any acquisition finance facility to assist in funding the acquisition. Consequently, it is this vehicle that is directly subject to any interest rate fluctuations on that facility; the fund is only indirectly exposed through

its ownership of the vehicle. As such, it is this vehicle, not the fund that would enter into a derivative to hedge the interest exposure on the acquisition finance facility. The lenders under the acquisition finance facility expect to see this derivative in place, in the acquisition vehicle, as an important part of their protections against a payment default. They know that, if interest rates increase, their borrower will have the benefit of the derivative to help fund the increased interest payments that it owes to them. It would not make sense for the lenders if this derivative were entered into at the private equity fund level. The benefit of the derivative would be in the wrong place.

The legal issues considered in this chapter are potentially relevant in respect of any derivative use by a fund.

Potential advantages and disadvantages of entering into derivatives at fund level

Any fund deciding whether or not it should enter into derivatives at fund level will need to consider its specific circumstances carefully. In addition to legal considerations, it will want to understand the accounting treatment, regulatory consequences and tax impact of the derivatives. It will also want to consider the operational impact of the derivatives upon the fund.

Potential advantages of entering into derivatives at fund level

The primary benefit of entering into a derivative at fund level is, of course, that the fund will have the direct benefit of the derivative and the potential return, or risk protection, that the derivative provides. Where a particular risk directly affects a fund, it may not be commercially possible to hedge that risk at anywhere other than the fund level.

The fund may also be able to obtain better pricing for the relevant derivative by entering into it directly rather than via a fund-owned vehicle. The counterparty to the derivative may welcome the financial strength and risk profile of the fund, as that will enable it to enforce its rights directly against the fund.

The taxation treatment of the derivative may be better if the derivative is entered into at fund level rather than in an investment vehicle owned by the fund. This will depend upon the tax rules applicable to the structure.

Having an agreed derivatives platform (for example, having International Swaps & Derivatives Association (ISDA) Master Agreements and Schedules negotiated and signed with one or more counterparties) at fund level means that the fund can enter into multiple derivative transactions using the same centralised documents, rather than having the cost, complexity and delay of negotiating bespoke documentation – as would be required if each new derivative were instead to be entered into, on a case-by-case basis, by separate investment vehicles owned by the fund.

Potential disadvantages of entering into derivatives at fund level

There are possible disadvantages, however, for a fund in entering into derivatives directly. Although derivatives are entered into with the intention of increasing performance or mitigating risk, they often carry a downside exposure which the fund must manage.

The fund must monitor any permissions required under its constitutional documents to ensure that its use of derivatives does not fall outside its powers. This may be operationally burdensome, depending upon the scope of any such requirements. Permissions requirements are considered in more detail later in this chapter.

Additional operational burden may arise as a result of the increasing levels of international regulation of derivatives over recent years in response to the financial crisis – regimes

such as the European Markets Infrastructure Regulation (EMIR) and the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) have seen significant obligations imposed on parties entering into derivatives to report on, and actively mitigate the risk of, their derivatives. Even more onerous are regulatory obligations to clear specified classes of derivatives through approved clearing houses, and to post assets as credit support (margin) in respect of specified classes of derivatives. A requirement to post margin pre-supposes that a fund can monitor and respond to margin requirements, which may be on a daily basis. Some funds do not have the treasury resource to manage such processes and many do not have ready access to the sorts of assets that can be posted as margin collateral (not least, those which would need to rely on calling unfunded commitments from their investors – which typically have a 10 business day notice period – to fund margin calls). Even for those funds that do have access to this kind of resource, the deployment of assets as margin may have an adverse impact upon fund returns, and this impact may be significant.

Consequently, careful analysis of any regulatory obligations needs to be made by any fund that is considering entering into derivatives. This is a complex and dynamic area. Good examples of the pace of regulatory change are the proposed amendments to EMIR that will broaden the definition of "Financial Counterparties" (parties that are in-scope for material obligations such as mandatory posting of variation margin) so that it will extend to a broader range of funds than is currently the case; and changes to EMIR to take physically-settled FX forwards entered into by funds outside the scope of the mandatory variation margin regime. Sometimes regulatory impact can be reduced by careful structuring of the derivative or by using an appropriate vehicle to enter into the trade. This needs to be assessed on the facts.

The use of derivatives at fund level also adds a layer of complication in relation to other fund-level transactional documentation. As analysed in more detail later in this chapter, a fund that is using leverage will need to consider carefully the interaction between its loan facility documentation and its derivatives documentation.

Some of these issues might be mitigated by entering into the trade via a separate vehicle established by the fund. Whether particular legal or regulatory obligations then apply will depend upon the particular rule sets and facts involved. However, the use of a separate vehicle itself brings potential structural complication, particularly if the derivatives counterparty is not satisfied that the vehicle alone represents an adequate covenant and therefore requires some level of recourse against the fund itself (for example, by way of a guarantee by the fund of the vehicle's obligations). The impact of any such recourse to the fund would need to be carefully considered.

Constitutional considerations when entering into derivatives at fund level

A fund that is considering entering into derivatives at fund level will need to ensure that it has the power and authority under its constitutional documentation to do so (taking into account any limits on quantum/type of its derivative exposure – which may be contained in side letters with its investors).

Optimally, the question of whether, and in what circumstances, the fund is entitled to enter into derivative transactions should be considered at the formation stage with any permission, together with any parameters around that permission, clearly addressed in the constitutional documentation when the fund is established.

Constitutional limitations in relation to entering into derivative transactions

An express prohibition on entering into derivatives in the constitutional documents is usually the end of the matter, unless there are clear commercial justifications for seeking

an alternative method of authorisation, such as an express investor consent. Such express prohibitions are, however, relatively rare, although beware side letter provisions which may (deliberately or inadvertently) restrict the use of derivatives. More likely is that the constitutional documentation is silent on derivative use, which may create its own issues – particularly if the fund's legal counsel are required to give a capacity opinion on the fund's ability to enter into the derivatives documentation.

Examples of less terminal restrictions that may appear in fund constitutional documents are:

(a) *Prohibition from entering into speculative derivatives.* Here, the fund manager will need to consider carefully the nature of the derivatives to be entered into by the fund and whether, on a correct construction of the limitation language, they could be caught. For example, a derivative entered into to hedge interest rate exposure on a fund-level loan may not be speculative, as it is hedging a genuine risk faced by the fund. However, if the loan is repaid but the hedge remains outstanding (or if the nominal value hedged under the derivative is not reduced in line with repayments of the loan), then has the derivative become speculative? What if (as is the case with almost every subscription facility) the facility under which the loan has been drawn and repaid is revolving and it is likely that the facility will be redrawn? Similarly, if a derivative entered into at fund level is not hedging a risk to which the fund is directly exposed, but instead hedging a risk to which the fund is only indirectly exposed – for example, a risk to which an investee company is exposed – then would this alone cause the derivative to be categorised as speculative?

(b) *Limitation on wagering or gaming contracts.* This sort of limitation, sometimes seen in investor side letters, must be considered carefully on its terms. There could be an argument that derivatives, particularly those that are not simply hedging a risk to which the fund is directly exposed, may be characterised as wagers or gaming contracts.

(c) *Limitation on the level of financial indebtedness that the fund may incur.* If the constitutional documents contain limits upon the financial indebtedness that the fund is permitted to incur, then the fund will need to consider whether actual or contingent exposures under derivatives will constitute financial indebtedness and, if so, how the exposure under the derivatives will be valued for the purpose of modelling compliance with the relevant provisions.

Constitutional limitations in relation to granting credit support for derivative transactions

If the derivative transaction will require an element of credit support, whether by way of the posting of margin collateral or by way of the provision of a fund guarantee (if the derivative is being entered into by a fund vehicle), then the fund will need to ensure that giving that credit support is permitted under the fund's constitutional documentation:

(a) *Giving security.* Fund documentation will frequently circumscribe the fund's ability to grant security. This may be prohibited or limited by reference to either the value of collateral that may be posted or the assets over which security may be granted. There may also be limitations on giving security in respect of the liabilities of an investee company. The fund will need a clear understanding of how any such limitations operate and will need to design and monitor its derivatives usage to ensure that the limitations are not breached. The question of how any collateral is valued for this purpose is likely to be key.

Security under derivative contracts may be effected in a number of ways, including by the creation of security interests over collateral (as under the 1995 ISDA Credit Support

Deed (Security Interest – English law)) or by way of title transfer of collateral (as under the 1995 ISDA Credit Support Annex (Transfer – English law)).

(b) *Giving guarantees.* The fund may be required by a counterparty to guarantee the obligations of a fund-owned vehicle which has entered into derivative transactions. In these circumstances, the fund will need to consider whether its constitutional documents limit its ability to do so. A limitation could take the form of a direct limit on the giving of guarantees or, more commonly, it could be indirectly effected by including exposure under the relevant guarantee within another limitation (for example, a limitation on financial indebtedness).

If guarantees are so limited, then the fund will need to understand how the guarantee obligation is to be valued for the purpose of ensuring compliance with the limitation. For example, is the maximum contingent exposure used, or is the accounting value placed upon the guarantee used? The specific terms of the relevant constitutional provisions will need to be considered to answer these questions.

(c) *Giving indemnities.* Similarly to guarantees, the fund will need to consider whether its constitutional documents limit its ability to give indemnities in respect of derivatives and, if so, how the contingent liability under any such indemnity is to be valued for the purpose of the limitation. For example, indemnity language appears in the standard form 2002 ISDA Master Agreement.

Constitutional limitations on the ability to draw investor commitments to meet derivative payments

The fund will also need to consider what ongoing requirements there may be under the proposed derivative to make payments or to post collateral. The proposed source of any required cash or assets will need to be identified. If the fund wishes to use investors' uncalled commitments as a possible source, then the fund will need to confirm that commitments can be drawn down for this purpose. If the fund also has a subscription facility or other fund-level borrowing where the available facility is calculated by reference to uncalled commitments, the fund will also need to factor into its use of such a facility the effect of payments funded from undrawn commitments.

Other contractual permissions required for the fund to enter into derivatives at fund level

In addition to restrictions under its constitutional documents, a fund will need to consider the impact of any existing contractual restrictions to which the fund is subject – in particular, existing loan facilities.

The extent of any contractual restrictions will be a matter for the fund to determine by reference to the specific finance documents that it has in place. However, it is reasonable to assume that any fund-level loan facility will restrict the fund's ability to incur debt, give guarantees and grant security – subject to a relatively narrow suite of "permitteds" and a general permission "basket". This is now considered in more detail.

Contractual limitations under fund finance facility documentation in relation to entering into derivative transactions

Limitations commonly appear in fund finance documents that directly address the ability of the fund to enter into derivatives:

(a) *Restriction on entering into derivatives.* The underlying facility documentation should be reviewed for a restriction on entry into derivative transactions. Although a blanket

ban is unlikely, other restrictions are more common, such as limits around speculative derivatives and around derivatives lasting beyond a maximum duration.

(b) *Restriction on incurring financial indebtedness.* Fund finance facility documents will invariably restrict the fund's ability to incur financial indebtedness. The exposure of the fund under derivative transactions will often be treated as financial indebtedness – whether it is, or is not, is a matter of interpretation of the particular finance document. If derivative exposure needs to be treated as financial indebtedness, then the next question is how the exposure should be measured. The common measure is the mark-to-market value of the derivative from time to time, but again this is a question of interpretation of the contractual provision (other valuation measures may include mark-to-model or the notional value of the derivative). A fund may be able to mitigate this risk by negotiating a sufficiently large permitted "basket" in the limitation to allow for anticipated fluctuations in derivative exposure. It may also be possible for the fund to protect against unexpected movements in derivative exposure by including terms in the derivative that cap the fund's maximum exposure under that derivative at a pre-agreed level.

Contractual limitations under fund finance facility documentation in relation to granting credit support for a fund-level derivative

Fund finance documents will also commonly contain provisions that limit the fund's ability to give credit support in relation to derivatives, so if the fund may need to post margin collateral or give any guarantee in respect of the proposed derivatives, then those provisions will need to be considered:

(a) *Giving security.* Fund finance documents will invariably include a negative pledge that limits the fund's ability to grant security. This restriction will certainly apply to security over the investors' uncalled commitments and any collateral or deposit account into which any investor commitments are paid when called, but it will usually apply to the creation of other security as well. The fund will need a clear understanding of how any such limitation operates.

A fund that may be required to enter into security arrangements in relation to derivatives should seek to include appropriate permissions in its fund finance documentation to allow this activity. Whilst a subscription lender, for example, is unlikely to entertain any suggestion that the fund be permitted to grant bilateral security over its investors' uncalled commitments, it may be prepared to allow the fund to enter into an ISDA Credit Support Annex as credit support for exposure under any permitted derivatives activity. It may also consider allowing a derivative counterparty to share in its security package where adjustments are made to the borrowing base to reflect the fund's exposure to that derivative counterparty. This is considered in more detail below. A NAV lender, on the other hand, is likely to be more resistant to such arrangements as it usually has to look to fund assets other than uncalled investor commitments – including cash which is upstreamed from portfolio companies – for repayment. Any such lender would generally expect cash distributions to be applied in repayment of its facility rather than being used to collateralise derivatives exposure.

(b) *Restriction on giving guarantees.* If the fund proposes to give a guarantee in relation to the derivative, then it will need to ascertain whether its finance documents limit its ability to do so. This could be by way of a direct limitation on the giving of guarantees, or an indirect limitation where another restriction is broad enough to apply to guarantees (such as guarantees being designated as financial indebtedness for the purposes of the limitation on financial indebtedness or for any leverage-style financial covenant). If

so, the fund will need to understand how the guarantee will be valued for the purpose of the limitation. Equally, to the extent that it is commercially agreed that a derivative counterparty can share in the subscription lender's security package, the benefit of any guarantee given under the finance documents may extend to that derivative counterparty. In each case, the specific terms of the relevant finance documents will need to be considered.

(c) *Restriction on giving indemnities.* As with guarantees, careful thought must be given as to whether indemnities are limited directly or indirectly through any other limitation (such as a limitation on financial indebtedness) and if so, how the indemnity liability is to be valued for this purpose.

(d) *Priority arrangements.* As a precondition to the fund successfully negotiating permissions under its finance documents for the fund to enter into derivatives (and any related security or guarantees), the finance documents may require that the derivative counterparty joins into a priority agreement that regulates the relative ranking of the rights of the lenders under their loans and of the derivative counterparty under the derivative. Such priority arrangements are, however, rarely seen – probably because subscription lenders are prepared to rely on their security over the investors' uncalled commitments (and may not allow a derivatives counterparty to take bilateral security – second ranking (noting the conceptual difficulties under English law with second ranking assignments) or otherwise – over those uncalled commitments) and NAV and other lenders at the fund level would satisfy themselves that any such exposure was limited by ensuring that any baskets permitting such activities were relatively low. To the extent that a derivative counterparty is permitted to share in a lender's security package, which is considered in more detail below, this can usually be dealt with by including some relatively simple intercreditor-style provisions in the facility agreement.

A shared security package between a fund's lenders and its hedge counterparties

If a fund wishes to enter into derivatives on a secured basis – for example, to take advantage of cheaper pricing – it may find that its lenders are prepared to share their security package with the derivatives counterparties. The security package would be granted in favour of a security agent, which holds that security on trust for both the lenders and the derivatives counterparties. The benefit of any guarantee granted in favour of the lenders under the facility documents would also be extended to the derivatives counterparties. The lenders may be more likely to agree to such an arrangement if the derivatives counterparties which are entitled to share in the security package are also lenders (or affiliates of lenders) under the fund's facility.

Typically, the facility documents would contain a mechanic which allows the fund to allocate a portion of its borrowing base to either (i) a specified hedging transaction which is designated by the fund as a secured hedging transaction or (ii) any hedging transaction entered into under a specified hedging agreement which is designated by the fund as a secured hedging agreement. As any secured hedging transactions are documented under separate derivatives documentation – and do not therefore constitute utilisations of the debt facility – lenders would expect the aggregate amount of the borrowing base which can be allocated to all secured hedging transactions to be capped. Otherwise, the risk for the lenders is that a substantial proportion of the borrowing base is used for secured hedging transactions, resulting in a significant reduction in the lenders' income from the debt facility.

The onus is on the fund to allocate a sufficient portion of the borrowing base to the secured hedging transaction or transactions under a secured hedging agreement. In determining

how much to allocate, the fund will need to balance the need for headroom (to take account of potential mark-to-market fluctuations) with the fact that any headroom will (further) reduce the borrowing base for the purposes of its debt facility.

If the fund's exposure under a secured hedging transaction or series of secured hedging transactions exceeds the amount of borrowing base allocated to that transaction or series of transactions, it would typically be required to: (i) increase the amount of borrowing base allocated to that transaction (or series of transactions); (ii) post collateral for the excess (on a bilateral basis in favour of the derivatives counterparty); or (iii) close out transactions to eliminate the excess. Option (i) assumes, of course, both that the fund has capacity within its borrowing base to do so and that by doing so it would not exceed the overall cap on the amount of its borrowing base which can be allocated to secured hedging transactions. Option (ii) requires careful analysis of where the relevant collateral will be sourced from and the impact of applying that collateral for that purpose. From the lenders' perspective, it is critical to ensure that any claims of a derivatives counterparty under a secured transaction (or series of transactions) which are in excess of the borrowing base allocated to that transaction (or series of transactions) rank behind those of the lenders. The relevant derivatives counterparty should only rank *pari passu* with the lenders to the extent its claim is equal to or less than the borrowing base allocated to its trade or series of trades.

Further issues to consider under fund finance documents in relation to the fund entering into derivatives

There are a number of other potential points of interaction between a fund's debt facility documents and its derivative documents. These need to be considered by reference to the terms of the relevant documents, but common issues are:

(a) *Cross-default.* The fund should be live to any provision under the fund finance documents that will trigger an event of default under the fund finance documents if default occurs under the derivative documents. It is potentially explosive if, for example, a minor breach of a technical nature under the fund's derivative documentation, which is not a concern for the derivative counterparty, nevertheless triggers an event of default under the fund finance documents – potentially resulting in the loss of the fund facility. This is exacerbated by the standard form nature of the events of default under ISDA documentation – there may not be opportunity to negotiate the events of default so that they match the relevant triggers under the fund's debt facility.

    If the fund has to give such a cross-default trigger under its debt facility, the fund should seek to include language in the clause to mitigate its effect – for example, by limiting triggers to material breaches only (like a payment default); to breaches in respect of exposure in excess of an agreed threshold amount; to actual events of default rather than just potential events of default; or to events of default in respect of which the derivative counterparty actually takes enforcement action.

(b) *Financial covenants.* The fund will also need to consider the impact of any derivatives on the financial covenants (if any) contained in its fund facility. Whilst a pure subscription facility is unlikely to be preoccupied with anything other than uncalled commitments cover, NAV facilities (for example) are likely to contain a more comprehensive suite of covenants. When negotiating its fund finance documents, the fund should seek to tailor the terms of any financial covenant definitions and ratios so that anticipated derivative use does not erode headroom and, as the fund moves through its life cycle, the financial covenants do not inappropriately dictate the fund's derivative strategy.

Derivative use may impact upon a number of financial covenants:

1. *Uncalled commitments cover.* This financial covenant measures the level of financial indebtedness incurred by the fund against the quantum of its uncalled commitments. As noted above, the fund will need to understand to what extent derivative exposure (including any related guarantee) is included within financial indebtedness for the purpose of this covenant and how that exposure is measured.
2. *Interest cover.* This financial covenant, often seen in NAV facilities, measures the level of finance charges that the fund must pay under its financial indebtedness against net cashflow generated by its portfolio of investments. The fund will need to determine to what extent payments and other charges on its derivatives will constitute finance charges for the purpose of assessing compliance with the covenant.
3. *Loan to value.* This financial covenant, usually found in NAV or other "aftercare" facilities, compares the level of financial indebtedness to fund NAV. The fund will need to identify the extent to which the derivatives will either need to be included in the financial indebtedness calculation or will impact upon the NAV figure for the purpose of this covenant. Impact on NAV is more likely in circumstances where the derivatives have been taken out below fund level.

(c) *Availability of subscription facility.* The use of derivatives may impact upon the availability of a subscription facility (or other debt facility where the facility limit is dictated by the level of uncalled commitments). This is because the terms of the debt facility may require that – when calculating the borrowing base – the uncalled commitments are reduced by the amount of any derivative liabilities (and any guarantee given in relation to derivatives).

More generally, if the fund proposes to use the subscription facility to fund payments, or to source collateral under its derivatives, then the fund will need to ensure that the subscription facility allows such use.

Issues to consider under the derivatives documentation

The fund will need to negotiate its derivatives documentation by reference to its own circumstances and needs. Among the matters that the fund should consider are:

(a) *Recourse.* The fund will want to ensure that its derivative documents reflect the correct separation of liability and recourse across its fund structure.

(b) *Cross-default.* The fund should carefully consider the extent to which a default under its fund finance documents could give rise to a termination right under its derivatives (for example, under paragraph 5(a)(vi) (Cross-Default) of the 2002 ISDA Master Agreement). The fund should seek to include language to mitigate the effect of any such trigger.

(c) *Additional termination events.* Derivative counterparties will sometimes seek to include additional termination events (ATEs) in their derivative documents, where their counterparty is a fund that can have serious repercussions for that fund:

1. *Uncalled commitments cover.* This termination event is triggered if the financial indebtedness of the fund exceeds an agreed ratio of the fund's uncalled capital commitments. Borrowings under any fund level facility will almost always fall within the definition of financial indebtedness.

   The problem with this ATE is that a reduction in the fund's uncalled capital commitments is by no means necessarily a sign that it is in financial difficulty. Indeed, funds will be positively seeking to draw down investor commitments

in order to invest them! A focus on uncalled commitments makes sense in the context of a subscription facility, but careful consideration is required when such provisions appear in derivative documentation. For example, where commitments have been invested, it may be appropriate for a component of fund NAV to be counted in the test in place of the deployed commitments, similar to the mechanics used in hybrid fund finance facilities.

2. *NAV floor.* This termination event is triggered if the fund NAV drops below a particular level. The problem with this ATE is that a successful fund expects to reduce its NAV as it realises assets and returns value to investors. Conversely, "zombie" funds which continue well beyond their scheduled termination date, or which are not being actively managed, may not trigger this ATE. Any trigger based on a NAV floor means that the fund should not plan to have derivative transactions outstanding with the relevant counterparty significantly beyond the point where it expects to enter into the realisation and distribution phase.

   In crude terms, whilst the need for derivatives may reduce as the fund's life cycle moves to the realisation and distribution phase, it often does not disappear entirely. If a particular counterparty refuses to agree to there being appropriate flexibility in the NAV floor trigger (for example, a step down following the realisation of assets in line with the fund's strategy), the fund would want access to one or more alternative counterparties who do not insist on a NAV floor trigger that would prevent derivative use towards the end of the fund's cycle.

3. *NAV movement.* This termination event is triggered if the fund's NAV decreases by more than prescribed amounts (or percentages) over particular periods. This trigger is difficult for a fund if it has not been calibrated to deal with expected NAV movements – particularly where it is seeking to return cash to investors during the realisation and distribution phase, or where it wishes to "flip" an asset early in its investment period (which could trigger a dramatic decrease in NAV if it is the only, or one of a handful of, investments made by the fund at that date). The fund should seek to mitigate any such trigger appropriately (for example, adjusting the trigger movement thresholds to reflect different stages of the fund's life; adding back distributions to investors which remain eligible for recall; or applying the trigger only to decreases that have a material adverse effect upon the fund's ability to perform its payment obligations under the relevant instrument).

(d) *Use of collateral.* In addition to the issues relating to collateral highlighted above, funds should note that to the extent the fund is required by regulation to post collateral in respect of its derivatives, it may not be possible for the fund to control the amount and frequency of collateral by setting large transfer threshold amounts and minimum transfer amounts. The ability of funds to use such mechanisms is increasingly limited by derivatives regulation such as EMIR.

Conclusion

Any fund that is thinking about the use of derivatives at fund level needs to consider its position very carefully. Although the analysis for any particular fund is fact-specific, the points discussed above are recurrent issues that it would be helpful for any fund to bear in mind when carrying out its assessment.

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In October 2015, Charlie co-presented a seminar on legal documentation at the inaugural Fund Finance Association Conference in London.

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