UCITS Funds Participating in New Money Transactions - Obstacles and Potential Approaches

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Overview of issue

UCITS funds too often have experienced a substantial erosion of value during restructuring transactions due to their inability to participate in new capital contributions. In these situations, the new money providers are often able to extract enhanced economics from the restructured company, greatly impairing UCITS funds' recovery prospects.

UCITS Eligibility

- The European Union's (the "EU") Undertakings for Collective Investment in Transferable Securities ("UCITS") framework sets out minimum criteria that fund assets must meet in order to be considered eligible investments for UCITS funds (EU retail funds)[1]
  - These rules are based on the guiding principles of diversification[2] and liquidity; a UCITS fund seeks to achieve the latter by restricting portfolio exposure largely to investments[2] in transferable securities and money market instruments admitted to trading on an eligible market (EU markets or other qualifying liquid markets specified in the prospectus of the UCITS fund) ("Eligible Investments")[3]
  - A number of additional investment restrictions and concentration limits curtail the permitted exposure of a UCITS fund to any single issuer, other funds, derivatives, unlisted securities and other investments and activities. For example, UCITS are generally not permitted to make loans.[4]

The Impact of UCITS on Credit Fund Participation in Restructuring Transactions

- UCITS funds that have invested in Eligible Investments, e.g. debt securities listed* on an eligible market, are often precluded from participating in the restructuring of the debt issuer as a result of the mandatory investment restrictions.
- This means that, unless the restructuring results in the securities offered to creditors constituting Eligible Investments (or the UCITS fund can use the 10% "allowance" to invest in assets other than Eligible Investments), the UCITS fund is not able to recover any of its investment.
- Given the changes in market conditions, this issue is likely to become more prevalent in the near to medium term. The interests held by UCITS are often not large enough to allow the UCITS to influence the terms of the restructuring.
- New capital in debt restructurings is most often provided in the form of a high interest super senior loan with generous allocations of equity and fees attached to it
- The new money securities offered to creditors in connection with the restructuring are often unlisted and may not constitute Eligible Investments.
- Where the UCITS creditors are unable to participate, other creditors will receive the UCITS fund's share of the recovery value attributable to new money providers
- By comparison, US 40 Act mutual funds (i.e. retail products) are able to participate in the new money restructurings by making loans or holding illiquid securities, and to provide backstop facilities.
- Moreover, where UCITS funds can otherwise participate in the new money issuance, they cannot provide guarantees and, accordingly, are unable to provide a backstop for a new money facility at an amount greater than their pro-rata share (based on pre-restructuring holdings), thereby limiting the funds' access to lucrative back stop fees
- A viable solution to these problems is long overdue

[1] As the UCITS rules are enshrined in a "minimum harmonisation" EU Directive, EU member states have the discretion to apply additional requirements or requirements that differ from those in the UCITS Directive. Accordingly, there is some jurisdictional variation in the scope and application of the UCITS investment restrictions;
[2] Investment in Eligible Investments is subject to an overall diversification requirement (the "5/10/40 rule"), which limits exposure to a single issuer at 5%, which can be raised to 10% with respect of 40% the assets of the UCITS; in addition, UCITS concentration limits restrict holdings of a single issuer's securities to 10%;
[3] Securities that are listed on a stock exchange or traded on a regulated market; only 10% of a regulated fund's net assets can be allocated to instruments that are deemed to be illiquid;
[4] Though certain EU Member State's interpretations of the UCITS rules have previously allowed for an argument favouring holding loans under limited and specific conditions, there may be a growing concern that such loans are not permitted

- A representative group of managers of UCITS funds has approached the European Leveraged Finance Association ("ELFA") to coordinate an effort to assess the situation, consider potential solutions, and possibly lobby for reforms to the fund legislation
- In the past few months, ELFA has further analysed this topic with the support of Houlihan Lokey ("HL") and Akin Gump, and the following potential ideas (which are not mutually exclusive) are being considered:
  1. Participating in New Money via a debt-issuing [or securitisation] SPV;
  2. Standardised New Money Structure;
  3. Transferability of New Money Participation Rights
- These potential approaches are outlined in further detail on the following pages.

Key Next Step

ELFA is considering options that could, in certain scenarios, allow UCITS funds to participate in new money transactions, preserve value, or allow for recoveries of distressed investments.

All of these options would require analysis by individual UCITS fund management companies and their compliance teams and local law input, based on the facts of the particular restructuring situation at hand. In addition, they would generally require advance engagement with competent regulatory authorities.

Accordingly, the approaches discussed herein do not constitute recommendations. None of the approaches has been approved or evaluated by any regulatory authority. ELFA would be happy to work with its member firms to facilitate such engagement on a co-ordinated industry basis

Summary of Obstacles for Participation in a Debt Restructuring Transaction

The below items have been identified as the principal obstacles limiting the ability of a UCITS fund to participate in the new money of a restructuring transaction

	Overview	Competitive Implications
Inability to Invest in New Money Facilities that aren't "Transferable Securities" or "Eligible Investments"	▪ In the context of a restructuring, new money may be structured as a loan or unlisted securities as opposed to a liquid instrument (e.g. a listed bond) ▪ UCITS funds are typically restricted from making loans or investing in unlisted securities, thereby limiting their ability to seek recovery value for distressed investments	▪ New money providers are often able to extract enhanced economics from the restructured company leaving UCITS funds with the prospect of little remaining value ▪ Relative to funds that are not bound by UCITS regulations, UCITS funds may experience lower recoveries through restructurings of existing investments and, consequently, overall lower returns
No Transferability of Participation Rights	▪ The right to participate in the restructuring (as a result of the original investment) is not generally transferable and a UCITS that is unable to participate due to regulatory restrictions (e.g. structure of the new money) has no de facto right to sell its participation right to another party	▪ Allowing UCITS funds to transfer their participation rights would allow funds to recover some value in connection with a restructuring, even if they cannot participate ▪ In line with the previous hurdles, an inability to transfer participation rights may negatively impact recoveries and returns
Cannot Underwrite Greater than Pro-rata Share of New Money	▪ UCITS regulated funds are not typically able to underwrite or provide backstop facilities in an amount greater than their pro-rata share of new money, despite a willingness to do so ▪ This is a result of UCITS regulations that prohibit funds from providing guarantees with respect to the obligations of another	▪ Limiting a UCITS fund's ability to participate in backstop facilities with respect to a greater than its pro-rata share of a new money investment prevents the fund from receiving fees associated with the same ▪ Accordingly, UCITS funds may have to forego fees for low-risk underwriting arrangements that other non-UCITS investors can receive

PRELIMINARY CONCLUSION ON THE CURRENT SITUATION

The restrictions outlined above may negatively impact UCITS funds' returns as they prevent UCITS from realising value and participating in the economics of restructuring the debt of a distressed investee company.

This places investors in European retail funds at a disadvantage compared to investors in professional investor funds or in US mutual funds (i.e. the 40 Act funds).

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Potential Approaches to Facilitate Value Realisation – Requires Engagement with Regulators

Following discussions with ELFA members, certain potential approaches have been summarized below, together with certain related considerations/limitations. The suitability of these approaches is highly fact-dependent and some or all of the approaches below may be unavailable to specific UCITS funds. Engagement with competent regulatory authorities should be underaken as part of considering Options A or B below, and ELFA would be happy to liaise with members to facilitate such engagement. The below does not constitute advice or a recommendation with respect to any actual or potential transaction or structure.

		Potential Approaches		
		1. Participating in New Money via a debt-issuing SPV	**2. Standardised New Money Structure**	**3. Transferability of New Money Participation Rights**
Summary		▪ A manager or a third party (e.g. an investment bank) sets up an SPV (possibly a securitisation vehicle) that will issue bonds that are Eligible Investments ▪ SPV to provide the new money by way of a loan; or hold unlisted debt or equity securities ▪ UCITS funds would subscribe to a bond issued by SPV structure ▪ Bond to meet the criteria for an Eligible Investment	▪ A market standard new money structure ensuring new money instruments are Eligible Investments ▪ Develop a white paper that outlines key structural terms that a new money investment would have to include to enable UCITS funds to hold / invest in the new money instruments ▪ Reduce cost and time needed for analysis ▪ Regulatory guidelines need to be met. In the absence of a listing, UCITS funds typically require the following: ▪ Details of the security reported on Bloomberg ▪ Presence of a market maker ▪ Real asset backing the security	▪ Allow UCITS funds to transfer the right to participate in a new money transaction rather than forego participating in its entirety ▪ UCITS funds would receive some form of consideration (cash or Eligible Investments) in return for transferring their participating rights to a willing counterparty
Could this approach facilitate value realisation?	**Could this allow UCITS to Gain Exposure to New Money Facilities that aren't "Eligible Investments"?**	▪ **Yes** – SPV could make the new money investment and UCITS funds would invest in the securities issued by SPV	▪ **Yes** – Could enable UCITS funds to participate in new money	▪ **No** – Approach would not solve this problem explicitly, but it could improve recoveries / returns
	Transferability of Participation Rights	▪ **No** – However, transferability would potentially no longer be an issue	▪ **No** – However, transferability would potentially no longer be an issue	▪ **Yes** – Could directly resolve this issue
	Cannot Underwrite Greater than Pro-rata Share of New Money	▪ **Yes** – UCITS funds could "overfund" SPV, which would provide the backstop; SPV to return any unused capital to UCITS funds	▪ **No** – Unlikely to address this concern	▪ **No** – Unlikely to address this concern
Considerations and Limitations		▪ Banks may not be willing to provide this service due to limited fee potential; cost and capital drag (particularly in respect of risk retention for securitisations) ▪ Indirect cost to UCITS fund(s) of setting up and a a structure ▪ Although this has been used in the past, Irish and Luxembourg regulators have placed this alternative under heavy scrutiny ▪ Needs regulatory approval as overfunding SPV could be considered an indirect guarantee	▪ Restructuring company/ other creditors may find it cumbersome and more expensive to implement instead of issuing unlisted securities or a standard loan ▪ Structure needs to satisfy requirements under at least Irish and Lux UCITS rules (possibly also UK & other) ▪ Max. 10% of the outstanding securities of a single issuer investment limit	▪ Relevant where the SPV or standardised new money structure approaches are not viable ▪ May require consent from restructuring company or other creditors

About ELFA:

ELFA is a professional trade association comprised of European leveraged finance investors from over 60 institutional fixed income managers, including investment advisors, insurance companies, and pension funds. The ELFA seeks to support the growth and resilience of the leveraged finance market while acting as the voice of its investor community by promoting transparency and facilitating engagement among European leveraged finance market participants. For more information please visit ELFA's website: www.elfainvestors.com.

About Houlihan Lokey:

Houlihan Lokey guides clients through the complex financial and strategic challenges they face during each stage of their business lifecycle. As a leading advisory-focused independent investment bank, they are able to serve as a trusted advocate to our clients across a number of key disciplines. Through our nine dedicated industry groups and financial sponsors efforts, we provide the focused expertise to help advance our clients vision. Houlihan Lokey has the largest worldwide financial restructuring practice of any investment banking firm, with offices and experienced professionals located across the globe. Since its inception in 1988, the restructuring group has advised on more than 1,400 restructuring transactions with aggregate debt claims in excess of $3.0 trillion. With more than 250 dedicated restructuring professionals worldwide, our group has significant presence domestically and internationally. We serve clients domestically and around the world, providing extensive resources to staff each case and serve our clients. Our broad base of clients and extensive experience allow us to understand the dynamics of each restructuring situation and the needs, attitudes, and positions of all parties in interest. Please visit: https://hl.com/

About Akin:

Akin is a leading global law firm providing innovative legal services and business solutions to individuals and institutions. Founded in 1945 by Richard Gump and Robert Strauss with the guiding vision that commitment, excellence and integrity would drive its success, the firm focuses on building lasting and mutually beneficial relationships with its clients. Our firm's clients range from individuals to corporations and nations. We offer clients a broad-spectrum approach, with over 85 practices that range from traditional strengths such as appellate, corporate and public policy to 21st century concentrations such as climate change, intellectual property litigation and national security.

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