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# An Introduction to Secondaries

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It is not unusual to hear the term "secondaries" in the fund finance world. It is thrown around conversationally and references arise frequently in market updates and panel discussions. For anyone not familiar with the term "secondaries," we thought it would be useful to provide a concise introduction, including what secondaries are, why they are popular and how a secondary transaction is documented.

**What are Secondaries?**

The private equity secondary market (commonly referred to as the "secondaries" market) refers to the buying and selling of investments in private equity funds. An acquirer of an investment in a private equity fund also assumes any remaining unfunded capital commitment to the fund.

**Why Sell Secondaries?**

Investments in private equity funds are illiquid. Investors do not have rights of redemption and generally must wait for a fund to liquidate investments through a public offering or sale of the underlying portfolio companies in order to realize their investment in the fund. A secondaries sale allows an investor to realize that investment early. A seller is often motivated by a desire to lock in attractive underlying fund valuations or to generate liquidity to reinvest into other opportunities.

**And Why Buy Them?**

A buyer of secondaries is able to evaluate the holdings and performance of a fund before committing to the purchase of an interest in the fund. Secondaries therefore have a different risk profile when compared to primary investments in private equity funds, where the investor is committing to an investment in an entity that has no track record and holds no assets. A buyer in the secondaries market is also drawn to attractive valuations and shorter time horizons for realization of a return on their investment.

## What Fund Documents Are Typically Required in Secondary Transactions?

1. Purchase and Sale Agreement

The main document in a secondary transaction is the Purchase and Sale Agreement ("PSA"). The PSA sets out the terms and conditions of sale between the buyer and seller, including the various rights and remedies of the parties, the closing conditions and, of course, the purchase price.

The purchase price is synced to a specific date, typically the most recent valuation date of the fund, which is commonly referred to as the cut-off date. Any distributions or contributions occurring prior to the closing date are accounted for from the cut-off date, and the purchase price is adjusted accordingly.

The PSA also details expenses or losses that are excluded from the sale. Examples include tax liabilities and losses arising from breaches of representations and warranties under the related subscription agreements or side letters of the seller, in each case arising prior to the closing date, since it would arguably be unfair for the buyer to bear such risk.

The PSA also includes an indemnity, making the buyer whole for any obligations arising prior to the sale and indemnifying the seller for certain liabilities other than the excluded obligations set out above.

The PSA also includes representations, warranties and covenants that are provided by both the buyer and the seller. The seller usually represents that it has title of the assets it is transferring and that it is not subject to any material litigation that could impact the secondary transaction. The buyer relies heavily on the seller's representations in a secondary transaction.

Provisions allowing the buyer to terminate the transaction are also commonly included.

2. Transfer Agreement

The transfer of the fund interest between the buyer and seller is typically documented in a tripartite Transfer Agreement, which is provided by the fund and entered into by the buyer, the seller and the fund. The Transfer Agreement contains the consent of the private equity fund or its general partner to the transfer of the secondary interests from the seller to the buyer and specifies the documentation that the buyer must deliver to the fund, including a subscription agreement and additional know-your-customer/anti-money laundering documentation.

3. Additional Deliverables

It is necessary for both the buyer and seller to carry out due diligence on the underlying fund documents, which typically include a limited partnership agreement, a subscription agreement, and, to the extent applicable, a side letter.

- The Limited Partnership Agreement

  The most important provisions to review are the transfer provisions, which explain the process required to transfer the fund interest from the seller to the buyer. The transfer provisions will specify if there is a right of first refusal, the length of the notice period for

the transfer, who must consent to the transfer, additional conditions precedent required to effect the transfer (such as the delivery of legal opinions or the payment of fees), and whether the buyer will be admitted as a substitute partner such that no residual liabilities remain for the seller.

- The Subscription Agreement and Side Letter

  The subscription agreement of the seller is helpful in confirming ownership of the secondary interest. Further, a review of the seller's subscription agreement and side letter (if any) will disclose elections, rights and waivers that are relevant to the seller's investment. The buyer may wish to discuss with the fund's general partner the extent to which such elections, rights and waivers will apply to the buyer's investment after completion of the secondary sale.

If a subscription credit facility is already in place for the fund, this will also need to be considered. Specifically, if the existing investor is included in a borrowing base, the parties will need to determine if the applicable transfer reduces the borrowing base such that a pre-payment will be required. The transfer provisions of the subscription credit facility will also need to be reviewed to make sure the transfer complies with the terms thereof.

**Secondary Fund Finance**

Buyers can finance an acquisition of secondaries interests.  Such financing may be provided by the seller of the secondaries, in the form of a secured or unsecured deferral of the buyer's purchase price obligation under the PSA, or by a financing provider that accepts the secondaries interests as collateral. Typically, the secondaries are owned by a special purpose vehicle ("SPV") and the seller or financing provider (as applicable) will take security over the shares of the SPV, in addition to the accounts of the SPV into which distributions from the underlying investments are paid. In the event of enforcement, the lender will be entitled to sell the pledged interests in the SPV or to take control of the SPV and the SPV's bank accounts so that it will be the sole beneficiary of any distributions paid to the SPV.

Lenders and borrowers have become more and more sophisticated in secondary financing transactions over time. Our team continues to see more complex credit facilities being negotiated due to the unique nature of each transaction. We expect to see a continued growth of secondaries in the fund finance world in 2020.