Investor Transfers: Lender Considerations in an Everchanging Fund Finance Market

January 10, 2025

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Although transfers by investors of their interests in a fund have always been a feature of subscription / capital call facilities, as of late, there has been a palpable uptick in investor transfers and this trend is set to continue, due to a multitude of factors.

This article explores the driving factors for the increase in investor transfers, the implications for rated subscription facilities and securitisations, how loan documents customarily deal with investor transfers, and due diligence considerations.

Why the increase in investor transfers?

The recent increase in investor transfers is mainly attributable to the continued growth of the secondaries markets: 2024 was projected to be a record year for the private equity secondaries market with estimates ranging from $140 billion to $150+ billion in volume due to increased GP- and LP-led activity.

On the GP-led side, a muted fundraising environment – in part driven by fewer viable exit opportunities in a high interest rate environment and the consequent slowdown in distributions to investors – has resulted in GPs holding so-called “trophy assets” for longer to extract more value before exiting. The adoption of continuation structures is at an all-time high as GPs have looked to engineer liquidity for investors via such vehicles and reset holding periods.

On the LP-led side, investors increasingly use secondaries as a portfolio management tool to correct overallocations to private equity funds. As the secondaries market continues to grow, so too has its use as a legitimate source of liquidity and a viable means of active portfolio management for investors. Demand for liquidity across the secondaries market has seen the birth of innovative new strategies and structures for investors, with capital being raised by dedicated GP-led / single-asset vehicles, ’40 Act / evergreen funds, and new entrants from multi-strategy alternative investment firms.

The increase in secondaries market activity has inevitably resulted in more investor transfers. Lenders are therefore having to dedicate an increasing amount of time considering these transfers and their impact on subscription facilities.

How do loan documents deal with investor transfers?

As most readers know, the identity of a fund’s investors is crucial to a lender’s credit assessment in a subscription facility: as the lenders’ secured recourse is against the uncalled capital commitments of the investors in a fund, the fundamental credit risk is on such investors duly funding capital contributions.

The prudent lender therefore should ensure that transferee investors are reputable and will fund capital contributions to repay a subscription facility, if required. Typically, they will also seek the inclusion of some or all of the following protections in their loan documents:

- an information undertaking that requires the borrower to notify any full or partial transfer by an investor of its capital commitments in the fund (alongside a general obligation to notify the lenders of the occurrence of any Exclusion Events);
- an information undertaking that requires the borrower to provide key investor details for each transferee investor (e.g., name, contact details, amount of capital commitment transferred, etc.), together with all corresponding investor documentation (e.g., subscription agreement, side letter, transfer instrument, etc.);
- a confirmation by the borrower in each utilisation request that the identity of all investors remains unchanged and that there has been no investor transfer since the borrower’s most recent confirmation of the investor base;

- a mandatory prepayment triggered upon an investor transfer to a sanctioned person that is in violation of applicable law, rule, regulation or any fund document;
- a mandatory prepayment triggered if an investor transfer results in a borrowing base deficiency, for such amount required to cure such borrowing base deficiency; and
- with respect to any cornerstone investor (i.e., any investor whose commitments represent a significant proportion of the total eligible investor commitments), a consent right in favour of the majority lenders or an event of default for any transfer of such cornerstone investor's capital commitments.

The composition of a fund's investor base has a direct impact on the creditworthiness of that fund. Clearly, this is of particular importance for providers of subscription finance, and so changes in the identity of investors (particularly the "eligible investors" whose undrawn commitments are taken into account for financial covenant purposes) typically impact the amount a lender will advance to such fund under a subscription facility.

How a subscription facility agreement treats an investor transfer depends on whether the facility employs either of the following approaches with respect to financial covenants:

(i) a coverage ratio approach (i.e., which presumes the inclusion of all "eligible investors", measured against the borrower's indebtedness) or a flat advance rate approach (i.e., which presumes the inclusion of all "eligible investors" and applies against them a lower, flat advance rate); or

(ii) a borrowing base approach (i.e., which includes certain investors as eligible investors based on them satisfying certain eligibility criteria (such as a minimum credit rating) and then applies a single or differing advance rates against those investors depending on how they are classified for the purpose of the borrowing base).

Regardless of the approach adopted, the default position under a subscription line typically will be that the transferred commitments are excluded for financial covenant purposes, subject to certain limited exceptions.

Where a coverage ratio (or flat advance rate) is used, the inclusion of a transferee investor and its capital commitment in the coverage ratio typically remains subject to lender discretion (subject to either all lender consent or majority lender consent), determined by reference to a lender's internal ratings and/or criteria. Whether, and the extent to which, a lender advances funds against a transferee investor therefore tends to be under more control by the lenders than may be the case where the facility employs a borrowing base approach.

Where a borrowing base is used, such inclusion will often be more "objective" as lenders customarily use a combination of external credit ratings and more "factual" internal criteria – accordingly, the approval and inclusion of transferee investors in borrowing base facilities may be (but is not always) automatic, subject to prior satisfaction of such "objective" criteria. However, in the European market, it not uncommon for lenders to push for complete discretion to veto the inclusion of the uncalled commitments of any transferee investor, even where a borrowing base model is used. Borrowing base facilities will also typically include concentration limits which restrict the percentage of total eligible investor commitments that can be held by any one investor or class of investor (e.g., rated investors, pension plans, HNWIs etc.). For this reason, lenders may be comfortable automatically giving borrowing base credit to the capital commitments that are transferred to a pre-existing eligible investor, to the extent such transferred undrawn commitments do not exceed any relevant concentration limits.

Irrespective of the approach taken by the subscription facility, the circumstances that trigger the transferred commitments being excluded for financial covenant purposes are generally the same – e.g., if there are any defects or other issues (such as cease funding rights, irresolvable sovereign immunity rights or heavy overcall limitations) in the investor documentation of the transferee investor. Similarly, in all types of facility, there is likely also to be an overarching "aggregate" limit on the amount of capital commitments that can be transferred, often set at around 15% or 20% of overall capital commitments and sometimes lower, before the cumulative transfers trigger a repayment obligation.

If the fund is an SMA, lenders generally will seek to prohibit all investor transfers, subject to all lenders' consent.

Due diligence considerations

Whilst LPAs usually prohibit investor transfers without the GP's prior consent and are subject to compliance with the transfer process set out in the LPA (which customarily requires the transferee investor to agree to be bound by terms identical to those binding on the transferor investor under applicable fund documents), LPAs and side letters often include provisions obviating the GP's consent right with respect to transfers to affiliates of an investor. Generally, such transfers should not be a cause for concern for lenders as, regardless of whether such transfer is permitted under the LPA or any relevant side letter, such transfer should still result in the commitments being excluded for financial covenant purposes. Whilst the ultimate beneficial owner of the investor may remain the same, some lenders may be uncomfortable lending against the commitments of any affiliated transferee that is fundamentally less creditworthy than the transferor (e.g., unrated subsidiary or SPV investor of a rated or well-capitalized parent entity). For this reason, lenders may require some form of credit support from the parent (or other creditworthy entity) of the relevant affiliate as a condition to the inclusion of the affiliate transferee as an eligible investor.

Irrespective of whether a transfer is to an affiliate of an existing investor or to a third party, lenders (and their counsel) should focus their legal due diligence on the following issues:

- have the transferor investor and the transferee investor entered into a transfer instrument (e.g., a transfer agreement);
- does the transferor investor have an existing interest in the fund that it can convey pursuant to that transfer instrument;
- does that transfer instrument duly document the transfer of the correct amount of the interest being transferred;
- does the transferee investor assume all rights and obligations of the transferor investor attached to the interest being transferred pursuant to that transfer instrument;
- are the names of the transferor investor and the transferee investor consistent with the other fund documents – it is critical to ensure the interest purported to be transferred belongs to the correct transferor investor and that the name of the transferor investor in the transfer instrument is consistent with the name stated in the relevant original subscription agreement;
- does that transfer instrument contain all requisite notice information for the transferee investor such that a lender or the security agent has all information necessary to issue a binding capital call on the transferee investor;
- has the transferee investor entered a side letter. If yes, customary legal due diligence needs to be conducted on that side letter; and
- has notice of the existing security over the uncalled capital commitments of the fund granted in connection with the subscription facility been duly delivered on the transferee investor?

Other considerations for lenders – rated facilities, credit risk insurance, and securitisations

Insurance: As established, the investor base of a fund directly impacts a lender's credit analysis of such fund in a subscription facility. Lenders therefore need to be alive to the impact of investor transfers on applicable credit risk insurance. Ordinarily, investor transfers do not result in a change in the price of insurance premiums, as customarily these are quoted based on a percentage of the margin the lender charges the borrower on the subscription facility. However, if a transfer concerns a cornerstone investor or other significant investor that materially impacts a lender's credit risk under a subscription facility, insurers usually expect (and may require) lenders to update their pricing so the insurer also benefits from higher insurance premium earnings alongside the lender. Hence, the prudent lender should be aware that insurers therefore usually require notification of all investor transfers.

Ratings: With the increased use of credit ratings for subscription facilities, lenders of rated facilities need to consider the impact of investor transfers on ratings. A key metric for all major credit rating agencies is the credit quality of the investor base, typically calculated by a credit rating agency assigning each investor in the collateral pool an individual rating. Changes in the investor base therefore impact a subscription facility's rating where the credit rating is a "monitored rating" (i.e., where the credit rating agency reviews the rating regularly and ad hoc if there is a material change to the investor base, as opposed to a "point in time" rating), particularly if the transfer concerns a cornerstone investor or another significant investor. Lenders originating subscription facilities with a view to syndicating to insurance providers and other ratings-sensitive lenders should be particularly alive to investor transfers as resultant ratings changes may impact the marketability of their subscription facilities.

Securitisations: With the growing market interest in subscription facility securitisations, originators of and investors in securitisations of subscription facilities, in particular, may query the impact of investor transfers on such securitisations. Transfers by cornerstone investors may result in a subscription loan in the reference portfolio no longer meeting the eligibility criteria (or the inclusion of such transferee investor may be deemed a material modification) such that the facility falls out of the reference portfolio. As cautioned by multiple major credit rating agencies, originators of, and original lenders under, subscription facility securitisations therefore need to ensure any eligibility criteria are sufficiently expansive and flexible to address any investor transfers (particularly for cornerstone investors) and to permit the replenishment of the reference portfolio to account for any subscription facilities which drop out of the portfolio due to a failure to meet eligibility criteria.

Conclusion

As secondaries markets continue to grow and investor transfers become increasingly common in a fund finance environment where the use of ratings and securitisations continues to grow, lenders need to be more alive to investor transfers now more than ever. In this environment, it is crucial that lenders strike the right balance and build into their loan documents sufficient flexibility to allow for investor transfers whilst retaining sufficient lender protections.

Three Weeks To Go Until the Future of Fund Finance | Europe

January 10, 2025

We're looking forward to The Future of Fund Finance | Europe, on 28 January at The Landmark Hotel in London. Cadwalader is proud to be a lead sponsor and have Partners **George Pelling** and **Nick Shiren** speaking at the conference, sharing their insight on key industry topics.

The full-day conference will provide the chance to gain the latest insights from leading issuers and investors as they examine how alternative funding structures are reshaping the fund finance market.

George Pelling will be a panelist on "The Spectrum of Structures in Fund Finance." Learn more about what he plans to cover **here**.

Nick Shiren will be a panelist on "Comparing Fund Finance Technology Under Different Regulatory Regimes." Learn more about what he plans to cover **here**.

With only three weeks to go, stay tuned for updates on the agenda and confirmed speakers.

View the agenda **here**.

View speakers **here**.

Announcing Global Symposium Agenda

January 10, 2025

The Fund Finance Association is delighted to share the agenda for the upcoming 14th Annual Global Fund Finance Symposium, taking place February 24-27, 2025 at the Fontainebleau Miami Beach.

This year's conference promises to be an exciting event, featuring a diverse lineup of keynote speakers, expert-led sessions, and ample networking opportunities.

Whether you're an industry veteran or new to the field, there's something for everyone.

Details

February 24 - February 27, 2024

Fontainebleau Miami Beach

4441 Collins Ave.

Miami Beach, FL 33140

Full Agenda: **2025 Global Symposium Agenda**

Register **here**.

Closing Soon: FFA-DEI Emerging Leaders

January 10, 2025

Nominations are still open! The FFA and Diversity in Fund Finance would like to support and recognize individuals in the industry for their outstanding overall contributions to furthering diversity, equity, and inclusion ("DEI") efforts in the fund finance market, their workplace, and/or the broader community. The FFA is excited to bring back the DEI Emerging Leaders initiative!

The FFA and Diversity in Fund Finance know and understand that there continues to be the need of collective work to help increase diversity and drive change within our industry. We believe the DEI Emerging Leaders Initiative will help recognize the hard work of individuals, bring more attention to these important efforts, and encourage broader participation.

As the Fund Finance market continues to grow and evolve, we believe this type of initiative is even more important to provide a platform of recognition to the next set of leaders within our community, and as such successful nominees recognized as DEI Emerging Leaders will receive one complimentary ticket to the FFA Global Symposium in 2025!

Do you work with someone who has made contributions to DEI in the fund finance industry? Or, are you someone dedicated to furthering DEI efforts, particularly in the fund finance industry? If so and if you (or your nominee) meet the following criteria, we want to hear from you!

Nominations are open until January 10th, 2025.

Criteria

The following individuals are eligible to nominate themselves or be nominated:

- any individual who self-identifies as diverse (broadly defined, including without limitation: culture, race, gender identity, ethnicity, sexual orientation, disability, etc.) and
- any non-diverse individual who is an ally to individuals who identify as diverse.

Emphasis in selection will be placed upon the following:

- Individuals who have contributed to or supported the pillars of the Diversity in Fund Finance initiative:
- educating and connecting with students in order to help open the pipeline of diverse talent into the market;
- being a facilitator of action to advocate for positive change;
- striving to create opportunities of advancement for diverse professionals; and
- fostering an open, inclusive, respectful space for everyone no matter their background.

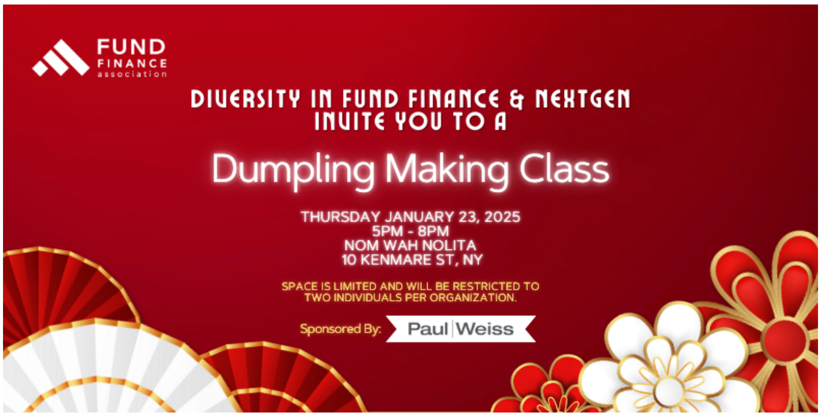
The individual must work and live in the continental United States of America at the time of the FFA Global Symposium in 2025.

Generally, only one individual will be selected from an organization, and emphasis will be placed on those earlier in their career. Please get in touch with Natasha Puri with any questions.

Nominate **here**.

Celebrate Lunar New Year 2025 With Diversity in Fund Finance & NextGen

January 10, 2025



Join the Fund Finance Association for an evening of networking, celebration, and culinary creativity as they ring in the Year of the Snake!

This special event will feature an interactive dumpling-making workshop where you'll learn the art of crafting delicious dumplings, alongside opportunities to connect with fund finance professionals and sub-committee members.

Together, we'll celebrate the Lunar New Year's themes of transformation, wisdom, and growth in a vibrant and engaging setting.

Event Details:

Date: Thursday, January 23rd, 2025

Time: 5:00 - 8:00 pm ET

Location: Nom Wah Nolita, 10 Kenmare St, New York, NY 10012

Space is limited and will be restricted to two individuals per organization.

Register **here**.

Fund Finance Tidbits – On the Move

January 10, 2025

The following individuals are on the move in the fund finance industry:

Congratulations to **Tom Hoge** who has joined the Huntington National Bank Fund Finance team. Tom joins the team as a Senior Managing Director based in the bank's Chicago office. He deepens the already impressive team's bench at the senior level with 25 years in the finance industry and a decade of that in the fund finance space. He joins from Silicon Valley Bank where he led SVB's Global Fund Banking Group in the Midwest.

The growing HNB fund finance team is led by senior managing director and well-known fund finance banker Brad Boland and now numbers 14 team members across three offices.

Fund Finance Hiring

January 10, 2025

Fund Finance Hiring

Here is who's hiring in Fund Finance:

MUTB-NY is seeking an Fund Finance Account Officer- VP to join its office in New York. The VP will work through all aspects of the transaction lifecycle to help the team originate fund finance transactions, including both subscription finance and NAV based facilities. Learn more **here**.