

Memorandum

GP-Led Secondary Transactions Alert: Recent Developments

May 24, 2023

Two recent developments relating to increasing investor protections around GP-led secondary transactions (also called “adviser-led secondary transactions”) by the Securities and Exchange Commission (“SEC”) and the Institutional Limited Partners Association (“ILPA”) could lead to potential changes in processes around these deals. The SEC adopted new reporting rules for sponsors that engage in such GP-led transactions and ILPA has released its own revised guidelines for such transactions.

SEC Quarterly Reporting Rule

Early last year, the SEC proposed two rules that specifically targeted adviser-led transactions: a requirement that private fund managers must report to the SEC within one business day upon the occurrence of an adviser-led transaction and a mandate that investors be provided a fairness opinion and a written summary of certain material business relationships between the adviser and the opinion provider in connection with an adviser-led transaction. The SEC has now adopted one of those proposed rules (with certain modifications), requiring all private equity fund managers that engage in an adviser-led secondary transaction to report such transactions within 60 days after the quarter in which such transactions occurred. Such quarterly reporting will be on Form PF, a confidential form relating to private funds and intended to be used by the Financial Stability Oversight Council (“FSOC”) for systemic risk oversight purposes.

The SEC has noted that receiving this information on a quarterly basis will provide timely notice of these private equity events and important information for its regulatory programs, including examinations, investigations, investor protection efforts, and policy relating to private fund advisers. The SEC believes it will also improve its, and the FSOC’s, ability to evaluate material changes in market trends at the reporting funds by providing information on certain events that could significantly affect both investors and markets more broadly.

The increased timeframe for reporting adviser-led secondary transactions is welcome news to sponsors, who had been concerned with the originally proposed one-business day reporting requirement. However, sponsors are still wary of how the SEC may use such information, and whether reporting the closing of an adviser-led secondary transaction will trigger an examination or investigation. The SEC has indicated that these transactions include a higher potential for conflicts of interest or fund distress and generally may signal an investor protection issue at a particular fund, and these transactions may present an opportunity to flag situations where the SEC may need to more carefully evaluate whether conflicts of interests have harmed investors.

The SEC defines an “adviser-led transaction” as one initiated by the adviser (or any related persons) offering private fund investors the option of (i) selling all or a portion of their interests in the existing fund; or (ii) converting or exchanging all or a portion of their interests in the existing fund for interests in another vehicle advised by the adviser (or its related persons). Single-asset, multi-asset, strip-sale, full-fund restructurings and private tender offers would all generally be considered adviser-led transactions subject to the new rule. If an adviser-led secondary transaction (or other reporting event, including investor election to remove a fund’s general partner or to terminate a fund’s investment period or a fund) does not occur during a particular quarter, then an adviser will not be required to file a report for that quarter. These reports are only required to be made by the sponsor initiating the transaction, not by any investor, and will be required beginning in November 2023.

The SEC has not yet addressed the proposed rule on requiring a fairness opinion from an independent provider, but the ILPA guidelines do suggest that such an opinion should be obtained for all GP-led transactions.

New ILPA Guidelines for Continuation Fund Transactions

In response to what ILPA refers to as “growing LP frustrations around these transactions,” the organization issued new guidance last week on continuation funds, which follows their broader paper on GP-led secondary transactions published in April 2019. The newly-issued guidance largely restates and extrapolates the contents of ILPA’s 2019 guidance on GP-led secondary transactions, and focuses on four key areas of concern: conflicts mitigation, transaction process and timing, deal terms and documentation and recommendations for investors. The general guiding principles of the guidance are that (i) continuation fund transactions should maximize value for existing investors, and (ii) rolling investors should not be left in a less favorable position than if the transaction had not occurred. Given the tremendous variety in, and bespoke nature of, continuation fund transactions, ILPA emphasized that their guidelines are intended to provide general parameters and may not be universally appropriate.

CONFLICT MITIGATION

The guidelines recommend that GPs:

- present the rationale for the proposed transaction to the LPAC of the existing fund at the earliest possible opportunity (ILPA suggests even prior to hiring an advisor for the transaction) and should have already explored alternative avenues for obtaining liquidity for the relevant asset(s);
- present all conflicts (even if pre-cleared by the governing documents of the existing fund) to the LPAC;
- run a competitive bidding process including validation of valuation (ILPA suggested a fairness opinion from an independent financial adviser, a partial disposition to a third party or an arms-length transaction through a minority stake could all be helpful);
- the LPAC review and approve any break-up or termination fees payable in the event the transaction is not completed;

- disclose all necessary information so that the LPAC may consider proposed conflict waivers and the broader investor base may evaluate its decision to roll or sell (ILPA lists recommended disclosures on the bids and process, information on the selected asset(s) and other information when the transaction is especially complex); and
- provide parity of information as between (i) the LPAC and the investors who do not sit on the LPAC as well as (ii) the existing investors and the new investors.

PROCESS AND TIMING

ILPA recommends that in connection with any continuation fund transaction:

- sponsors should engage experienced advisors to facilitate the transaction that such, advisors should be accessible to the investors and the LPAC should review the advisor's role, scope of services and the fee arrangement;
- the LPAC should have the opportunity to review the proposed deal terms at least 10 business days prior to finalizing such terms;
- investors should be given the longer of 30 calendar days or 20 business days to make an election, with flexibility to extend such period for limited partners subject to institutional legal requirements to the extent this would not present substantial execution risk; and
- investors who do not make any election should be treated as having elected to sell, which is a departure from ILPA's 2019 guidance on such situation being that those investors be placed in the continuation fund with no change in economic terms from the existing fund (the "status quo" option).

DEAL TERMS AND DOCUMENTATION

ILPA's latest guidance recommends certain best practices for deal terms and documentation for continuation fund transactions, including that:

- rolling investors receive the benefit of any existing fund side letters in connection with their investment in the continuation fund, to the extent applicable;
- continuation fund formation expenses be borne by rolling investors and new investors;
- transaction expenses be subject to a cap;
- selling investors only bear their pro rata portion of sale transaction expenses;
- should the LPAC approve a transaction that does not ultimately proceed, the existing fund should bear such broken-deal costs;
- there should be no crystallized carry for rolling investors and all carry accruing to the GP related to selling investors' interests should be rolled into the continuation fund;

- investors should be offered a status quo option (same economics as in the existing fund); and
- any dilution of existing investors should be done on a fair and reasonable basis.

RECOMMENDATIONS FOR EXISTING INVESTORS

ILPA's recommendations to existing investors in funds that may be participating in a continuation fund transaction are to generally collaborate with the sponsor, including by:

- preemptively establishing internal protocols to respond to these transactions (such as approvals, underwriting process, and understanding legal requirements);
- working with sponsors to set timing expectations around reviews, negotiations and approvals;
- reviewing existing fund documentation, new documentation/deal terms, models and materials necessary to be informed and to ensure informational symmetry between the existing investors and potential new investors; and
- going forward, consider the potential for GP-led transactions when diligencing, reviewing and negotiating fund documents in connection with potential primary investments.

Key Takeaways for Sponsors Considering GP-Led Secondary Transactions

In addition to the new reporting requirement, the SEC's recently published exam priorities noted a "focus on RIAs to private funds with specific risk characteristics, such as: ...private funds involved in adviser-led restructurings, including stapled secondary transactions and continuation funds." This is a clear signal that the SEC is focused on GP-led secondary transactions, and in particular on the inherent conflicts of interest involved, while ILPA noted that as continuation fund transactions increase in prevalence, greater transparency and consistency will be critical given the conflicted nature, short timelines and complexity of these transactions.

The SEC specifically noted two concerns in its recent final published rule. First, the SEC notes that investors are often given very short timeframes in which to choose whether to cash out of their investment or participate in an adviser-led secondary transaction and are not always able to sufficiently diligence the transaction before they must decide to whether to commit to it. Second, the SEC noted that, while some advisers seek advisory board consent for these transactions, these advisory boards are comprised of only the largest investors in the fund and the adviser does not seek consent from the remaining investors. ILPA also focused on ensuring a longer timeframe for investors to make their elections with respect to continuation fund transactions.

As a result, we expect that sponsors engaging in a GP-led secondary transaction will generally provide investors at least a 20 business day timeframe (which is the most common timeframe, the minimum required by private tender offer rules, and the recommendation in the new ILPA guidance).

In addition, sponsors may want to consider seeking consent from a majority of all investors in appropriate circumstances, even if the fund's governing documents only require advisory board approval, given the SEC's noted concern on approvals.

Finally, given the highly bespoke nature of these transactions, although existing investors will likely push for much of the ILPA guidelines to be implemented, sponsors will likely choose only certain of the recommendations as some won't be practical or relevant in the specific circumstances of such transaction.

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