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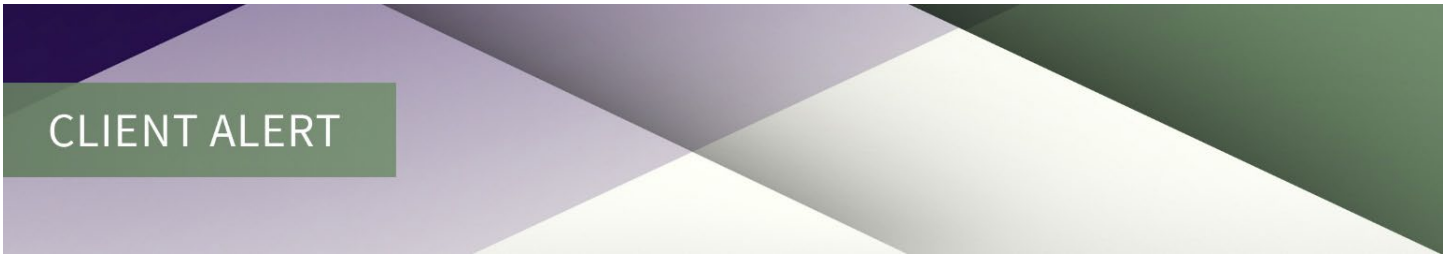

New SEC Rules for Private Fund Advisers Impact GP-Led Secondary Transactions

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AUTHORS

Adam Aderton | James E. Anderson | Matthew Block | Justin Browder
Arash Farhadieh | Philip Isom | Larissa Marcellino | Lior J. Ohayon

On August 23, 2023, the Securities and Exchange Commission (the "SEC") adopted new rules under the Investment Advisers Act of 1940 (the "Advisers Act").[1] These rules and amendments (the "Final Rules") substantially modify several existing regulatory requirements and create significant new obligations for investment advisers to private funds. According to the SEC, the Final Rules are intended to increase private fund investor protections by: (i) providing more transparency; (ii) imposing additional limits on conflicts of interest; and (iii) requiring additional governance mechanisms for client disclosure, consent, and oversight.

This alert briefly summarizes how the Final Rules are expected to impact and inform GP-led secondary transactions.[2] We continue to carefully review the rules and intend to provide an in-depth alert assessing the Final Rules and the implications for private fund advisers more generally.

1 *Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews*, Investment Advisers Act Release No. 6383 (Aug. 23, 2023), available here. On September 1, 2023, six private equity and hedge fund trade groups filed suit against the SEC in the Fifth U.S. Circuit Court of Appeals seeking to vacate the Final Rules. This client alert expresses no opinion on the merits or likely outcome of such proceeding and assumes the Final Rules will become effective on the compliance dates noted by the SEC in the Final Rules.

2 *Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews*, Investment Advisers Act Release No. 5955 (Feb. 9, 2022), 87 Fed. Reg. 16886 (Mar. 24, 2022) (the "Proposed Rules"), available here and here. Our client alert discussing the Proposed Rules is available here. The SEC defines a GP-led secondary transaction as any transaction initiated by the adviser or any of its related persons that offers the private fund's investors the choice between: (i) selling all or a portion of their interests in the private fund and (ii) converting or exchanging all or a portion of their interests in the private fund for interests in another vehicle advised by the adviser or any of its related persons.

a. General

In the release accompanying the Proposed Rules (the "Proposing Release"), the SEC noted that private fund advisers have become increasingly active in the secondary market and the number of "adviser-led" transactions has increased, with the deal value of such transactions representing a meaningful portion of the secondary market, particularly for closed-end private funds. The SEC further highlighted in the Proposing Release the inherent conflicts such transactions present where the sponsor is on both the buy-side and sell-side of a transaction that involves the sale of one or more underlying fund investments from one sponsor-advised client to a continuation vehicle managed by the same sponsor. Because a sponsor has the opportunity to earn management fees, carried interest and potentially other noneconomic benefits from the GP-led secondary transaction (such as stapled commitments to other sponsor-advised products), the SEC is particularly focused on mitigating the potential conflicts arising out of these types of transactions.

Conflicts can also arise in relation to the allocation of expenses and the granting of preferential side letter terms among the various constituents of investors that participate in GP-led secondary transactions, including: (i) new investors that capitalize a continuation vehicle to acquire interests in one or more portfolio investments from existing selling investors; (ii) existing fund investors that elect to either roll or reinvest in the continuation vehicle and thus continue exposure to one or more underlying portfolio investments that are the subject of the transaction; and (iii) existing fund investors that elect to take liquidity.

b. Fairness or Valuation Opinion

The SEC remains focused on the conflicts associated with valuation. As a result, the Final Rules provide that registered private fund advisers must obtain either a fairness opinion or a valuation opinion from an independent opinion provider when conducting a GP-led secondary transaction. In that regard, the Final Rules afford more flexibility for advisers than the Proposed Rules, which would have required advisers to obtain a fairness opinion rather than choosing between a fairness and valuation opinion.

In practice, the Final Rules do not change what is typical for the majority of GP-led secondary transactions with respect to valuation. In most GP-led secondary transactions, limited partner advisory committees (the "LPACs") are often tasked with reviewing and waiving conflicts of interest associated with the transaction, and as a condition to providing a waiver, LPACs will, as a matter of established market convention, require sponsors to obtain an independent fairness opinion or a valuation opinion. LPACs typically require such opinions even if there are other mitigating circumstances, such as a competitive auction process or a recent minority investment from a third-party investor.

The Final Rules will require an adviser to distribute the fairness or valuation opinion, along with a summary of any material business relationships the adviser has, or has had within the prior two years with the independent opinion provider, in each case, to the fund's investors prior to the termination of the election period (prior to the adoption of the Final Rules,

such opinions were generally furnished to existing investors on a one-off basis upon request). Prior to the adoption of the Final Rules, providers of fairness or valuation opinions have customarily required some acknowledgement that among other things, any opinion or other work product provided upon request to existing investors be furnished to such existing investors on an informational and nonreliance basis. Sponsors of GP-led secondary transactions and opinion providers should consider the least burdensome way of obtaining such acknowledgement from all fund investors in order to comfortably distribute such opinions to the entire existing fund investor base as required by the Final Rules.

c. Non-Pro Rata Allocation of Expenses

The Final Rules will require all private fund advisers to comply with prohibitions on certain restricted activities, including a prohibition on charging or allocating fees or expenses relating to a portfolio investment on a non-pro rata basis to private fund clients, unless certain requirements are met.

In GP-led secondary transactions, the allocation of expenses between the existing fund and the continuation vehicle is a heavily negotiated point between sponsors and lead investors. It is often the case that certain expenses related to creating the liquidity option for the existing fund investors (e.g., the cost of drafting election materials and associated disclosure and obtaining the fairness or valuation opinion noted above) are specially allocated to existing fund investors that opt to take liquidity as part of the GP-led secondary transaction. Regardless of how expenses will be shared, it is common in GP-led secondary transactions for such expenses to be allocated in a non-pro rata manner to certain classes or groups of investors. In those cases, and in the absence of language in the existing fund governing documents permitting such special allocations of expenses, a sponsor will often seek a waiver or amendment to the existing fund's governing documents permitting such special allocations in connection with seeking elections from existing investors.

In promulgating the Final Rules, the SEC noted that charging or allocating fees and expenses relating to a portfolio investment on a non-pro rata basis presents a conflict of interest because sponsors may have economic and/or other business reasons to charge or allocate fees and expenses to one fund client as opposed to another (e.g., differences in a private fund's fee structure, ownership, structure, life cycle and investor base). Although the Proposed Rules included an outright prohibition on non-pro rata allocations of fees and expenses, the Final Rules adopt a disclosure regime permitting non-pro rata allocations if such allocation is fair and equitable and the sponsor distributes to each investor a written notice of the non-pro rata charge or allocation (prior to such charge or allocation being applied) and a description of how it is fair and equitable under the circumstances. The SEC intends that such disclosure will enable investors to discuss the non-pro rata allocation with the adviser before being charged.

The disclosure documentation in GP-led secondary transactions tends to qualitatively disclose the types of expenses that will be borne by different investor groups, as between investors electing liquidity and investors electing to maintain exposure to the portfolio investments. We anticipate that market convention will evolve concerning the manner in which transaction expenses are disclosed to prospective secondary investors.

d. Preferential Treatment

The Final Rules prohibit sponsors from providing certain types of preferential treatment to an investor in a private fund that would have a material, negative effect on other investors, subject to certain exceptions; and other types of preferential treatment to any investor in a private fund, unless the adviser satisfies certain disclosure obligations. While not unique to GP-led secondary transactions, sponsors often provide side letters to their investors that accomplish a number of objectives, including providing preferential terms to strategic or large investors or accommodating specific disclosure requirements for public pensions, registered investment companies and other investors with idiosyncratic disclosure or reporting obligations.

The Final Rules provide that any preferential treatment related to any material economic terms given to any one investor must be disclosed[3] to all investors prior to accepting their investment in the fund and all other preferential treatment that is not related to a material economic term must be disclosed in writing as soon as reasonably practicable following the end of the fund's fundraising period in the case of a closed-end fund. The SEC noted examples of material economic terms as being related to cost of investing, liquidity rights, fee breaks and co-investment rights. Furthermore, the SEC noted that if any preferential portfolio company reporting or transparency is offered to one investor, it should be offered simultaneously to all investors.

It is often the case that sponsors of GP-led secondary transactions provide anchor or "lead" investors with preferential terms via side letters or additional covenants, reporting rights and other terms through a separate purchase or transaction agreement. Sponsors pursuing GP-led secondary transactions should be mindful of offering economic concessions in side letters, both to avoid delays in closing resulting from this new pre-commitment disclosure requirement and to manage any associated investor relations impact. We expect that best practices will dictate that all material economic terms be laid out in the continuation vehicle's partnership or similar agreement, as opposed to side letters, and we would expect that any terms benefiting the lead investor group contained in a separate purchase or transaction agreement be disclosed to all investors prior to closing the transaction.

Similar to the restricted activities rule discussed above, the Final Rules provide "legacy status" for preferential redemption terms and preferential information rights. Legacy status will apply to contractual agreements governing a private fund (including a continuation vehicle) that commenced operations as of the compliance date and that were entered into in writing prior to the compliance date, if the restrictions would require the parties to amend the governing agreements of the relevant private fund.

[3] The SEC did not clarify any particular form the disclosure must take but the Final Rules do require that the adviser must describe specifically the preferential treatment (e.g., the SEC noted that merely disclosing the fact that other investors are paying lower fees is insufficient; instead, the adviser must describe the lower fee terms).

e. Compliance Dates

The Final Rules provide for varied compliance dates for the rule provisions noted above, with advisers having $1.5 billion or more in private fund assets under management subject to a compliance date of 12 months, and advisers with less than $1.5 billion in private fund assets under management subject to a compliance date of 18 months, in each case, after the Final Rules are published in the Federal Register.

If you have any questions regarding this client alert, please contact the following attorneys or the Willkie attorney with whom you regularly work.

Adam Aderton
202 303 1224
aaderton@willkie.com

James E. Anderson
202 303 1114
janderson@willkie.com

Matthew Block
212 728 8288
mblock@willkie.com

Justin L. Browder
202 303 1264
jbrowder@willkie.com

Arash Farhadieh
212 728 8640
afarhadieh@willkie.com

Phillip Isom
212 728 8269
pisom@willkie.com

Larissa Marcellino
212 728 8039
lmarcellino@willkie.com

Lior J. Ohayon
212 728 8278
lohayon@willkie.com