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Secondary Transactions

Conflicts of Interest in an Evolving Landscape: Potential Areas of SEC Examination Risk for GP-Led Secondary Transactions

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Over the last several years, GP-led secondary transactions and continuation funds have experienced dramatic growth. In a market environment characterized by fundraising challenges, high interest rates and diminished M&A activity, GP-led secondaries offer sponsors a flexible and unique tool to manage competing strategic demands by offering liquidity to existing investors while preserving the sponsor's ability to optimize the value of existing "trophy" portfolio companies.

However, the conflicted nature of GP-led secondaries has garnered attention from the SEC and other regulatory authorities in recent years, including in the since-vacated private fund adviser rules (PFAR). In particular, the SEC's emphasis in its 2025 examination priorities on ensuring that advisors "adequately mitigate and fairly disclose conflicts of interest" suggests that GP-led secondaries will be an area of continued focus in future SEC examinations and enforcement activity irrespective of the changing U.S. administration.

This article explores several potential ways in which GP-led secondaries may garner greater SEC scrutiny in the future, including as to conflicts of interest in the auction process, the adequacy of LP advisory committee (LPAC) consents, the information parity between all types of participating investors and the equitable allocation of transaction expenses.

See "SEC 2025 Examination Priorities Feature Essential Compliance Concerns, Emerging Technologies and Several Notable Omissions" (Dec. 12, 2024).

Evaluating Bids

Cleansing Conflicts in an Auction Process

GP-led secondaries are intrinsically conflicted transactions. A GP-led secondary transaction entails one or more funds of a particular sponsor (Existing Funds) selling one or more portfolio companies or other assets (CVT Portfolio) to a new fund vehicle managed by the same sponsor (Continuation

Vehicle) and backed, at least in part, by capital provided by one or more new secondary investors (New Investors). The new capital is used by the Continuation Vehicle to acquire the CVT Portfolio at a price usually set by one or more "lead" investors (each, a Lead Investor).

As the Lead Investor supplies most of the Continuation Vehicle's new capital and is typically an institutional investor or large fund sponsor with a secondaries-focused team, the Lead Investor tends to negotiate the terms of the transaction for and on behalf of all New Investors. The underlying investors in the Existing Funds (Existing Investors) are typically offered at least two choices:

1. to "roll over" their current indirect exposure to the CVT Portfolio into the Continuation Vehicle (often with a variety of options, including a "status quo" option) (Rollover Investors); or
2. to receive sale proceeds in the form of cash by selling their indirect exposure in the CVT Portfolio to the Continuation Vehicle (Cash-Out Investors).

The sponsor, which stands on both sides of the transaction, must balance its competing fiduciary obligations to the Existing Funds and Existing Investors on the one hand, with its obligations to the Continuation Vehicle and New Investors on the other.

Basic steps a sponsor can take to cleanse a GP-led secondary transaction from a conflicts perspective are to:

1. conduct a competitive auction process with a price to be set by one or more Lead Investors, or piggy-back off a recent or concurrent transaction where an arm's-length third party independently sets price;
2. seek a fairness opinion issued by an independent, nationally recognized valuation firm indicating the price set is fair to the Existing Funds from a financial point of view;
3. provide clear disclosure to investors of all material terms, including descriptions of the potential conflicts of interest implicated by the transaction and the economics flowing to the sponsor; and
4. obtain the consent of the Existing Fund's LPs or its LPAC.

As GP-led secondaries have grown in complexity over time, however, satisfying a sponsor's competing duties has become more challenging.

See "Pressure Points When Performing GP-Led Secondaries, Including Valuations and Conflicts of Interest (Part Two of Two)" (Jun. 7, 2022); and "Evolution and Future of GP-Led Restructurings: Transaction Structuring Trends and Conflicts of Interest Management (Part One of Two)" (Jun. 2, 2020).

Financial Incentives When Inviting New Investors and Co-Investors

When a sponsor evaluates multiple bids as part of a GP-led secondary auction process, each bidder's monetary offer, along with any other terms or conditions attached to the offer, will typically drive the discussion of which bid to accept. A sponsor should also consider, however, whether its decision may have been driven – or could be perceived as having been driven – by other intangible factors that would primarily benefit the sponsor.

Given that GP-led secondaries can afford sponsors the chance to simultaneously forge new relationships with certain investors and reaffirm existing relationships with others, investor relations considerations may influence the sponsor's decision-making process. Those relationships can lead to contractual arrangements pursuant to which one or more New Investors agree to "staple" their commitment to the Continuation Vehicle to a separate investment in another sponsor-managed vehicle, which is typically referred to as a "stapled" secondary. One way to mitigate those conflicts is to identify the intangible items (*e.g.*, a stapled commitment) that could benefit the sponsor and avoid negotiating or requesting those items during the price discovery or auction phase.

Similarly, co-investor participation in GP-led secondaries (such participating co-investors, CV Co-Investors) may give rise to other conflicts of interest. Sponsors will generally have a financial incentive – and may also be contractually required – to facilitate CV Co-Investor participation, as it may convert fee-free capital into fee-paying capital. Sponsors should exercise caution, however, to ensure that both CV Co-Investors and Existing Investors are treated fairly. For example, if a GP-led secondary sales process fails to raise enough capital to completely buy out all Existing Investors opting to "sell," sponsors should carefully consider how any cutbacks are applied to all investors, including CV Co-Investors.

See "SEC Charges PE Sponsor With Improper Accelerated Monitoring Fees and Continuation Fund Transfer" (Dec. 14, 2023); and "SEC Sanctions Adviser for Inequitable Allocation of Deal Expenses Between Its PE Fund and Co-Investors" (Jul. 26, 2022).

Limits of LPAC Consent

Most private funds' limited partnership agreements grant the LPAC authority to clear conflicted transactions under the presumption that most LPAC members' interests are sufficiently aligned with those of a fund's LPs to enable the LPAC to fairly evaluate the transaction in question. However, GP-led secondaries can present unique challenges in this area.

Evaluation of Deal Terms

Following a successful auction process, the sponsor will typically disclose information to the LPAC about:

- the auction process;
- the bids the sponsor received; and
- the terms offered by the winning bidder.

After the LPAC receives that information, however, an argument can be made that each LPAC member will have a preliminary sense of whether the GP-led secondary, if approved, would present an attractive liquidity option to such member. Rather than evaluating the inherent fairness of the GP-led secondary and the propriety of the auction process, LPAC members may therefore be motivated to render a decision based on their own investment considerations and liquidity needs.

The potential misalignment of interests of LPAC members and LPs as a whole can be exacerbated by the fact that LPAC members tend to represent the largest Existing Investors. For example, LPAC members with larger commitments may face fewer liquidity constraints than smaller Existing Investors, making them more likely to roll over their existing capital into the CVT Portfolio. As such, LPAC members may be more interested in the terms offered to Rollover Investors, including the allocation of expenses to such investors, than the terms offered to Cash-Out Investors.

See "How Good Governance Frameworks Can Optimize Outcomes in Continuation Funds" (Mar. 15, 2022).

Second Generation Continuation Vehicles

In addition, conflicts of interest may arise when a sponsor seeks to launch a new Continuation Vehicle (Second Generation CV) to purchase some or all of the assets held by an existing Continuation Vehicle. Given that Lead Investors commonly negotiate the right to control a majority of the votes on a Continuation Vehicle's LPAC and typically hold a majority of the total economic interests in the Continuation Vehicle, the Lead Investors may effectively wield a unilateral right to approve the sale of the CVT Portfolio to the Second Generation CV.

In that scenario, Lead Investors will arguably prioritize their own investment considerations and liquidity needs over the interests of the Continuation Vehicle's investors as a whole. If a Second Generation CV is undertaken, the conflicts would be magnified in the event that one or more Lead Investors of the existing Continuation Vehicle were chosen to act as lead investors of the Second Generation CV. In addition to enhancing the potential conflicts between the Lead Investors and other Continuation Vehicle investors (as well as potential investors in the Second Generation CV), that result could exacerbate the appearance of self-dealing between the sponsor and any such Lead Investors.

Risk Mitigation Techniques

Ultimately, as with other potential conflicts of interest in GP-led secondaries, the risks posed by LPAC participation in the approval process is significantly mitigated through clear disclosure. Risks have also been substantially mitigated through the evolution of Delaware law and provisions in investment funds' governing agreements that provide nearly complete exculpation from liability and indemnification by the relevant funds. Specifically, under the terms of most investment funds' governing agreements, an LPAC member's indemnification and exculpation protections only fall away in the event of a non-appealable determination that liability resulted from an act of bad faith attributable to an LPAC member.

See "The Case for Independent LPAC Members" (Oct. 3, 2024).

Impairments to Information Parity

Prospective New Investors expect to receive detailed disclosure about a CVT Portfolio's performance history, the methodology used for the CVT Portfolio's valuation and any other information relevant to assess the CVT Portfolio's performance potential. To facilitate that review, sponsors commonly invite prospective bidders to participate in a due diligence process that offers bidders additional opportunities to evaluate the CVT Portfolio's strengths and weaknesses.

Although larger institutional investors with secondaries mandates often possess the skills and expertise required to "ask the right questions" about a CVT Portfolio, many Existing Investors may find themselves at a relative disadvantage unless a sponsor takes affirmative steps to ensure greater information parity. Given the wealth of information provided to New Investors during the auction process, sponsors should proactively take measures to ensure that Existing Investors receive comparable disclosure about the CVT Portfolio. The risk of information asymmetry is compounded by the passive investment profile of many Existing Investors and their comparatively limited experience and dedicated resources available for evaluating GP-led secondaries.

Cognizant of that risk, the Institutional Limited Partners Association (ILPA) released guidance (ILPA Guidance) advising that "GPs should endeavor to achieve parity in the information provided to the acquirer and to the LPs in the fund." To that end, ILPA suggests that Existing Investors should receive data room privileges that are in line with the access granted to bidders in the auction process. In keeping with ILPA's recommendations, future SEC examinations may focus on evaluating the extent to which sponsors facilitate information parity between New Investors and Existing Investors.

See "ILPA Guidance Promotes Equitable Framework for Continuation Fund Transactions" (Jul. 27, 2023).

Status Quo Woes

Sometimes sponsors offer a third option to their Existing Investors to retain their current exposure to the CVT Portfolio on terms substantially similar to those that apply to their investments in the Existing Funds – a so-called "status quo option." The term "status quo" has different meanings to different parties, however, and is not otherwise defined in any body of law.

Using the term "status quo" alone without any other description could be misleading as Existing Investors opting into a "status quo" option may think that they are waiving participation in a GP-led secondary entirely when that may not be the case. For example, some sponsors may intend to crystallize carried interest for Existing Investors but offer them the same economic terms as to the CVT Portfolio that they had before their continued participation in the GP-led secondary.

To mitigate the risks posed by those potential conflicts of interests, sponsors should fulsomely disclose both the manner in which "status quo" investors participate in GP-led secondaries and the considerations that may have informed a sponsor's decision to offer that option to its Existing Investors.

Expense Allocation Practices

Given the number of affiliated parties that participate in GP-led secondaries, a critical element of ensuring a fair process is to devise a transparent, principled basis for allocating transaction expenses between the Existing Funds, the Continuation Vehicle and any CV Co-Investors.

Despite the ILPA Guidance relating to the allocation of GP-led secondary expenses, those expenses are often shared on a non-pro rata basis following extensive negotiations. For instance, it is common for the Lead Investor to negotiate an arrangement whereby the Existing Funds (and particularly, Cash-Out Investors) agree to cover 100 percent of certain categories of expenses, such as:

- the cost of obtaining a fairness opinion;
- any fees incurred in connection with obtaining Hart-Scott-Rodino or other regulatory approvals; and
- the costs related to structuring the GP-led secondary, including the cost of:
  - negotiating the purchase agreement;
  - launching an Existing Investor election process; and
  - forming any holdings vehicles used to facilitate the GP-led secondary.

Similarly, the Continuation Vehicle – and particularly, New Investors and Rollover Investors – commonly agrees to cover 100 percent of its own organizational expenses and the reasonable out-of-pocket expenses incurred by the Lead Investor (in each case, generally subject to an agreed upon cap).

Although commonly employed in GP-led secondaries, non-pro rata expense-sharing arrangements create the potential for additional conflicts of interest. In particular, an argument can be made that the sponsor may be incentivized to shift the burden of bearing transaction-related expenses to the Existing Funds (which, as discussed, are generally borne by Cash-Out Investors) to create greater alignment with the Lead Investor and increase the amount of capital available for follow-on investments in the Continuation Vehicle. The fact that Existing Investors will generally be unable to participate in the negotiation process between the sponsor and the Lead Investor (outside of seeking LPAC consent) amplifies the risk of an unchecked conflict of interest arising.

Therefore, any bespoke expense allocation practices – particularly those involving non-pro rata allocations – should be clearly and fulsomely disclosed in the GP-led secondary offering documents. Further, the sponsor should ensure that any participating CV Co-Investors bear their share of transaction-related expenses alongside the Existing Funds. Given that expense allocations were a subject of SEC attention under the PFAR, there is added reason to believe that conceptual focus will continue to animate the SEC's examination and enforcement priorities.

See "Using Elements of the PFAR to Develop an All-Weather Approach to SEC Scrutiny of Private Fund Advisers" (Feb. 20, 2025).

Conclusion

When considering the SEC's examination priorities for 2025 and beyond, experts in the private funds field have already started to consider how the SEC's approach may change under the Trump administration and whether it will move in a more laissez-faire direction.

Although some experienced practitioners have opined that fewer private fund enforcement cases will be seen during President Trump's second term, the array of potential conflicts of interest implicated by GP-led secondaries makes such transactions a conspicuous subject for examination – particularly the quality and comprehensiveness of any related conflicts disclosure in GP-led secondary offering documents. After the latest amendments to Form PF come into effect in June 2025, the SEC will also have more visibility than ever before into the timing and terms of GP-led secondaries, which may increase attention on these transactions. Further, certain aspects of the PFAR may continue to color the SEC's examination priorities and criteria despite its demise.

See "PE Industry in 2025: Trump Administration's Likely Impact on Rulemaking, Examinations and Enforcement (Part One of Two)" (Jan. 9, 2025); and "Key Provisions for PE Sponsors in the Final Amendments to Form PF and Relevant Departures From the Proposal (Part One of Two)" (Jun. 29, 2023).

Accordingly, as GP-led secondaries continue to evolve and grow in complexity, sponsors should consider ways to effectively mitigate any associated conflicts of interest and more fulsomely communicate those considerations to their investors. Those measures will not only help to ensure that sponsors can better serve the interests and needs of their investors, but may also lessen the risk of adverse SEC examination outcomes.

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