STANDARDS BOARD FOR ALTERNATIVE INVESTMENTS

SBai
Standards Board for Alternative Investments

GP-Led Secondaries: Impact of New SEC Rule on Valuation & Conflicts of Interest

1. Introduction

On 23 August 2023, the Securities and Exchange Commission (SEC) introduced new rules and changes under the Investment Adviser Act of 1940 to bolster regulation of private fund advisers. These rules aim to protect investors in private funds by enhancing transparency in compensation schemes, sales practices, and conflicts of interest, and by imposing restrictions on practices contrary to public interest and investor protection.

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

One significant alteration in these rules is the Adviser-Led Secondaries Rule[1], which addresses conflicts of interest when advisers offer investors the choice between selling or exchanging their interests in a private fund for interests in another vehicle managed by the adviser or related parties. This rule, known as Rule 211(h)(2)-2, mandates advisers registered with the SEC to obtain and distribute a fairness or valuation opinion from an independent provider to investors before the due date for their election form.

This requirement marks a radical change as it is the first time the SEC has specifically mandated a fairness or valuation opinion in any transaction. The rule applies to secondary transactions initiated by advisers or related persons that allow investors to choose between liquidity and rolling their interests into another vehicle. The objective is to provide investors with better information and a more comprehensive understanding of financial aspects of deals. This should reduce chances of fraud and deception.

Advisers and investors can negotiate whether a fairness or valuation opinion is more suitable, even if competitive bidding or recent arm's length transactions have occurred. The rule insists on obtaining the opinion from an independent provider to mitigate conflicts of interest.

Additionally, advisers must provide a summary of any material business relationships between themselves (or related persons) and the independent opinion provider within the two-year period preceding the opinion's issuance date. This transparency should help prevent biased opinions.

The final rule requires advisers to distribute the fairness or valuation opinion and the summary to private fund investors, with record-keeping to support compliance. Compliance deadlines are staggered, with larger advisers given 12 months ($1.5bn of assets or more) and smaller advisers 18 months ($1.5bn of assets or less) to adhere to the new requirements. The rule would not apply to advisers that are not required to register with the SEC, such as state-registered advisers and exempt reporting advisers.

[1] Note: On 1 September 2023, several industry representative bodies and business trade associations filed suit in the US Court of Appeal for the Fifth Circuit, asking the Court to set aside the final Private Fund Advisers Rules adopted by the Securities and Exchange Commission (SEC) on 23 August 2023 on the grounds that they exceed the agency's statutory authority and are contrary to law. The outcome of the court case is highly uncertain and unlikely to be known until the second half of 2024.

Regulators are becoming increasingly focused on valuation and potential conflicts of interest in the real and illiquid asset space. In the United Kingdom, the Financial Conduct Authority (FCA) has also indicated that private fund valuation is an area it intends to review in the near future[2].

3. Regulatory Concerns

As deal flow slows in the private equity space and private asset valuations are becoming increasingly scrutinised against public market valuations, it may become more attractive for General Partners (GPs) to suggest to Limited Partners (LPs) that existing fund holdings be transferred to future vintages i.e., a cross-trade. This mechanism can provide LPs liquidity and negates the need for the GP to attempt to sell the fund asset in a market where it is not guaranteed they will achieve the carrying value the asset has been previously marked at.

The SEC has identified this mechanism as an area of concern, as the GP will typically be the party with valuation responsibility for the assets. This potentially creates a conflict of interest if GPs are incentivised to artificially inflate asset valuations to keep existing LPs happy, whilst also negatively impacting investors in future vintages who would thereby potentially pay inflated prices. In addition, GPs may also be eligible to receive fees for such transactions, dependent upon the wording contained within the fund's offering documents.

4. Fairness Opinion vs. Independent Valuation

Fairness opinions and independent valuations have been utilised for some time and will be familiar to most market participants in relation to M&A and private market valuation procedures. It is already common that Limited Partner Advisory Committees (LPACs) would request such evidence in their review and assessment of GP-led secondary transactions, prior to providing their support to proceed. The rule change makes this practice a requirement.

A fairness opinion will state that the economic terms of a transaction (i.e., price) is fair, from a financial point of view to a particular stakeholder. A fairness opinion does not however indicate that the best possible price has been received or paid. Fairness opinion providers can provide a range of services including examination of the specifics of the transaction or deal – such as the terms of the agreement, the asset or company and its financial condition, the nature of the transaction, the price of the transaction, the benefits and risks of the transaction, and other factors. Fairness opinions will typically require more work and analysis by the independent valuation agent given the consideration of a much broader range of components to a deal. Fairness opinions are also typically seen as an indemnification tool for LPACs and GPs to protect themselves against prospective future litigation. As such, fairness opinions are more expensive to conduct than an independent valuation.

Independent valuations tend to arrive at a defined price or range of prices based on various valuation methodologies at which a deal may be transacted, but may not consider the additional factors included in a fairness opinion.

5. Important Considerations

Regardless of which approach GPs and LPs decide to take, it is imperative that an independent provider is selected who has the capacity, competence, and experience to provide accurate and reliable information to the stakeholders. It should be assessed whether the provider has experience dealing with and evaluating the type of asset. Does valuation constitute an area of expertise for the provider? Do they

[2] *UK regulator to launch review of private market valuations*, Financial Times, access here: https://www.ft.com/content/ee008ac7-2f0f-4b65-a016-0e2ec00e8c26

provide similar services to the rest of the market? These are all important considerations that GPs and LPs must consider to ensure confidence in the valuation process and alignment of interests.

6. SBAI Standards on Valuation & Conflicts of Interest

The new rule will reduce the potential for conflicts of interest, but we should acknowledge that concerns surrounding valuation and conflicts of interest will remain with regards to the valuation of assets in the normal course of business – such as for striking NAVs which are then used to calculate fees owed to a GP. The SEC has not mandated the use of independent valuation agents or a fairness opinion with respect to ongoing portfolio valuation. The SBAI's standards on valuation and conflicts of interest seek to address some of the concerns raised by regulatory authorities and aims to create a framework for institutional investors and investment managers to ensure trust and integrity between stakeholders, for the ultimate benefit of our industry.

Examples: Conflicts of Interest addressed by the Alternative Investment Standards

Conflict of interest	Mitigation (examples)
Management fees based on value of assets might encourage over-valuation	• Independent valuation / segregation of functions • Governance framework for valuing hard-to-value assets • Valuation Policy • Investor disclosure • Review by fund directors *(Standards 5-9, 21)*
Performance fees based on NAV might encourage excessive risk taking or leverage by the manager ('roll the dice')	• Upfront risk disclosure (including use of leverage) • Risk management framework • Ongoing risk reporting to investors • Independent fund governance arrangements / review of adherence to investment policy *(Standards 1, 9-16, 21-22)*
Hidden fees charged to the fund	• Detailed upfront commercial terms disclosure • Comparability of fee methodology in offering document and financial statements • Standards addressing adverse changes of commercial terms *(Standard 2)*
Conflicts of interest between different investors	• Handling of redemptions / fair treatment of investors • Disclosure of existence of material side letters • Disclosure of existence of funds/accounts using the same investment strategy (as the investor fund) and potential material adverse effects *(Standard 1, 2)*

Standard 6.1 Valuation Policy Document

A document ("Valuation Policy Document") covering all material aspects of the valuation process and valuation procedures and controls in respect of the fund should be prepared. The Valuation Policy Document (which it is acknowledged will contain information which is proprietary to the fund manager) should be reviewed regularly by the fund manager in consultation with the fund governing body, and be made available to investors upon request on a confidential basis.

The SBAI envisages that in most circumstances the Valuation Policy Document will describe:

- the responsibilities of each of the parties involved in the valuation process;
- the processes and procedures in place that are designed to ensure that conflicts of interest are managed effectively;
- the relevant material provisions of any service level agreements (SLAs) entered into with third parties responsible for or involved in the valuation process (excluding details of commercial aspects of any such SLAs); and
- the controls and monitoring processes in place that are designed to ensure that the performance of any third party to whom the valuation function is outsourced is satisfactory.
- (…)

Source: Alternative Investment Standards, Valuations, access here: https://www.sbai.org/standards/

7. SBAI Activities

The SBAI will continue to explore the topic of valuations in our Private Market Valuation Working Group[3], which brings together our manager and investor community. Historically, we have provided guidance on a range of topics related to Alternative Credit, including Valuation and Conflicts of interest which can be accessed in the SBAI Toolbox.

We are keen to hear the views of any private equity, real estate, infrastructure, and venture capital investment managers who would like to contribute to this work to improve industry practices. If you would like to contribute, we invite you to contact the SBAI team at info@sbai.org.

[3] To learn more about the SBAI's Private Market Valuation Working Group and request to join, click here: https://www.sbai.org/group/private-markets-valuation-working-group.html