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Secondary Solutions in Asia: Navigating Regulatory Clampdowns

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Summary

- **Asia has seen strong growth in the demand for bespoke secondary solutions over the last 12 months and this is expected to continue in 2023 and in the near future, coinciding with increased regulatory and investor scrutiny.**
- **The SEC acknowledges the potentially beneficial nature of GP-led secondaries, which have the potential to be viable liquidity alternatives for underlying funds.**
- **A primary source of concern for the SEC when it comes to GP secondaries solutions is the actual and potential conflicts of interest.**

In the midst of a global recession and limited liquidity for private companies, many GPs are looking to secondary markets for additional liquidity alternatives. Asia, in particular, has seen strong growth in the demand for bespoke secondary solutions over the last 12 months, with this trend expected to continue in 2023 and beyond. However, the rise of secondary transactions coincides with increased regulatory and investor scrutiny.

- **Recent SEC developments**

On May 3, 2023, the SEC announced its final rule (SEC Final Rule) regarding certain amendments to Form PF, a confidential reporting form for registered investment advisers (RIAs). These amendments include a new requirement for all RIAs of private equity funds to file a new event report upon the closing of a GP-led secondary transaction within 60-days of the applicable fiscal quarter end. Such reporting must include the closing date and a brief description of the transaction.

The SEC Final Rule is the latest SEC initiative targeting secondary transactions, which has been a major focus area for the SEC since 2022. At the start of 2023, the SEC's release of its semi-annual Regulatory Flexibility Agenda on Jan. 4, 2023 (the Regulatory Agenda) included, in its proposed rules covering private fund advisers, requirements for a fairness opinion in connection with GP-led secondary transactions and additional disclosure of the material business relationships between the GP and such fairness opinion provider. Next, the SEC published, on Feb. 7, 2023, its Examination Priorities Report wherein the SEC stated that GP-led secondaries conducted by RIAs is a notable new and significant focus area of the SEC. Stapled secondary transactions and continuation funds were expressly called out as having "specific risk characteristics."

The SEC Final Rule sheds light on the SEC's thinking in connection with secondary transactions and solutions, in particular those initiated by the GP. The SEC highlighted that GP-led secondaries can be used as an attempt to restructure a struggling portfolio or to extend an investment beyond the contractually agreed-upon term, and such transactions can have a meaningful impact on the liquidity profile of a private equity investment or a private equity fund. The SEC further expressed concerns over the conflicts of interest inherent in many secondary transactions, especially where the GP is on both sides of the deal.

Encouragingly, the SEC also acknowledged the potentially beneficial nature of GP-led secondaries as a possible indication of strength in particular investments.

When done right, GP-led secondaries have the potential to be viable liquidity alternatives for underlying funds.

- **An overview of secondary solutions for Asian GPs**

Determining the correct liquidity solution for any given GP in the secondary market will inevitably be a bespoke exercise, which will vary based on many factors including the nature and timing of and circumstances surrounding the underlying fund assets, the capital needs of such fund assets, as well as characteristics of the fund's limited partner (LP) base, among others. In Asia, "GP-led secondaries" is still a topic that is viewed with much caution and many Asian GPs look at the PE secondaries market with hesitation, many having faced difficulties previously in finding buyers for their funds' minority growth equity holdings. There are two types of GP-initiated liquidity solutions that are quite popular with Asian GPs:

1. **GP in the buyer-consortium:** Under this structure, an Asian GP sells a fund asset to a buyer consortium where the same Asian GP also concurrently participates in the buyer-side, often by establishing a "single deal vehicle" managed by such Asian GP. One often sees the lead of such buyer-consortium to be an existing LP of the selling fund (structured as such in order to achieve an arm's length pricing process) and such existing-LP offers an allocation to the selling Asian GP's deal vehicle. From the Asian GP's perspective, it may desire to retain exposure in the investment and hopes to achieve that with funding from new investors (who may be attracted by the underlying asset's characteristics e.g., as a yield-generating long-life asset or as a shorter-term pre-IPO investment).
2. **Stapled or similar secondaries:** Under this structure, an Asian GP would sell a fund asset to third-party buyer(s), and such buyer(s) would either agree to commit new monies in the buying vehicle for further unrelated investments or otherwise agree to invest in other funds of the same Asian GP as part of the deal. This approach has been a popular route to enhance the fundraising of the new funds of such Asian GP. A primary concern for LPs of the seller fund is that a GP may have accepted a lower purchase price in exchange for the buyer providing additional available investment capital.

In recent years, the GP-led structure known as the continuation fund is also becoming more popular in the market. In many ways, the continuation fund is an extension of, and contains elements similar to, both the aforementioned GP-initiated liquidity solutions–where an existing fund sells a single asset or multiple similar assets to a new fund vehicle (the continuation fund) that is also managed by the same GP–but has as one of its core characteristics the optionality for existing fund LPs to sell their stake or roll their stake over to the new continuation fund (ideally, on a tax-free basis). New buyers of a continuation fund are brought in (often through an auction or other competitive bidding process) to pay out the selling LPs and, in some cases, to provide new capital to the continuation vehicle.

In all three types of transactions outlined above, LPs face similar issues relating to conflicts of interests. With increased SEC oversight to be expected surrounding such conflicted transactions, it is crucial for Asian GPs looking to pursue such secondaries solutions to implement fair practices and processes for all stakeholders involved. For the purposes of this discussion, the three types of secondaries solutions outlined above will be coined under the umbrella term "GP secondaries solutions."

- **Considerations prevalent in secondary solutions**

Asian GPs should pay attention to the following key considerations when structuring a GP secondaries solution.

A compelling business case

A compelling business case is fundamental to any successful GP secondaries solution. An extensive analysis should be conducted on the various liquidity options, followed by strong justification as to why a particular secondaries solution is preferred. In particular, it is recommended that an Asian GP put themselves in the shoes of the existing fund LPs, i.e. understanding the underlying commercial incentives for existing fund LPs should be at the forefront of such analysis.

In the context of conflicted secondary sales and stapled secondaries, LPs will almost always question a GP's business motive, and specifically question whether the selling price is lower than what the fund can obtain from a non-conflicted or unstapled secondary sale. The GP should focus their business case on alleviating LP concerns regarding pricing and giving LPs sufficient explanation of the commercial rationale for such transaction. Transparency with LPs will likely be key in such discussions.

In the context of a continuation fund, the core question in existing fund LPs' minds will inevitably be: should I sell or should I rollover? This core question is usually not a simple or quick decision. It takes time for LPs to properly assess their options, including potential tax impacts, and LPs may feel like they have no choice but to sell their exposure if the transaction timing is too short. GPs should take steps to make sure existing fund LPs are kept informed early on in the process, and that they are given sufficient time to review and ask questions. Simply put, existing fund LPs should be provided with two genuine choices and reasonable time to make an informed decision.

Mitigating conflicts of interest

One primary source of concern for the SEC and other regulatory authorities when it comes to GP secondaries solutions is the actual and potential conflicts of interest inherent in any such structure.

In both conflicted secondary sales and continuation vehicle contexts, the main conflict is one of self-dealing. A GP can be described reasonably as wearing "two hats"; on the one hand, as manager of the existing fund with fiduciary duties to existing fund's LPs, and on the other hand, either as a new buyer in a secondary sale context or as manager of the new continuation fund with fiduciary duties to the new vehicle's LPs. A GP may have incentives to price the transaction either higher or lower in order to: (i) increase performance metrics of the existing fund; or (ii) maximize crystallized carry (or minimize rollover carry) depending on the economics of the various fund vehicles.

There is a perception that LPs of the existing fund is the party that bears a disproportionate share of the risks of such pricing conflicts. After all, for a GP and/or new buyers, if the price isn't right, the deal can be further negotiated until it is acceptable. Existing fund LPs, on the other hand, are in a more precarious position of deciding between the binary choice of whether to sell or hold.

Further, while the existing fund's limited partner advisory committee (LPAC) are usually consulted and/or must approve any such secondary transaction, many Asian funds' LPACs consist of only a limited number of the largest anchor investors of such fund, some of whom may also be a buyer or co-investor in the same deal, and which LPAC act by majority decision. That is, once a GP is able to convince a few key LPs, LPAC approval can be obtained even if there are dissenting voices in the LPAC or in the broader LP base.

Instead, Asian GPs can consider revisiting their funds' governing documents to, if appropriate, provide the LP or the LPAC with a right to observe in the pricing process earlier, or the right to seek the LPAC's own separate fairness opinions.

It may also be beneficial for the GP to engage a third-party financial advisor to run a competitive auction or other bidding process, in order to provide the existing fund's LPs with the assurance and comfort of actual and perceived independence in the bidding process, and that the ultimate price is indeed a fair market price.

- **What's ahead for secondary solutions in Asia**

As primary fundraising in Asia continues to be difficult, increasingly GPs are turning to bespoke secondary solutions as a means of concurrently generating liquidity to existing LPs, as well as providing a source of new money for the GP. After all, as the SEC acknowledges, secondary transactions can be a strong sign of strength in trophy assets managed by good quality GPs.

However, Asian GPs hoping to pursue GP secondary solutions should be mindful of the increasing scrutiny over such transactions (regulatory and otherwise). Industry bodies such as the Institutional Limited Partners Association (ILPA) have recently published additional guidance on single and multi-asset continuation funds. The SEC will no doubt continue to be proactive in this space. Other regulators will likely follow suit. As such, Asian GPs will do well to build a solid understanding of the key considerations with respect to secondary transactions. Ultimately, when done correctly, such structures can truly be a "win-win-win" situation for all parties involved.