# SEC Private Fund Rule Reforms – GP Led Secondaries: Mandatory Fairness Opinion vs Valuation Report

## What is The Difference?

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On August 23, 2023, the Securities and Exchange Commission (SEC) adopted new rules (and amendments to existing rules) under the Investment Advisers Act of 1940 (Advisers Act) that enforce the SEC's objective to protect private fund investors by increasing transparency, competition, and efficiency in the private funds market.

One of the more technical sweeping changes includes a new requirement for SEC-registered advisors who execute a general partner (GP)-led secondaries transaction to obtain a fairness opinion or a valuation report from an independent advisory firm. In addition, the GP must provide a summary disclosure of material business relationships the GP has or has had with the advisory firm within the prior two years. In the context of these new rules, there are different GP-led structures where the SEC would mandate an independent fairness opinion or valuation report. Still, in certain instances, there would be no mandatory requirement (i.e., tender offers, cross-trades, etc.).

While the SEC observes that GP-led secondary transactions can provide advantages to both GPs and investors in terms of liquidity generation and increasing the timeline to optimize the value of future exits, it is important to consider the inherent conflicts of interest given that the GP is involved on both sides of the deal and can have objectives in the transaction that are different and not aligned to those interests of the limited partners (LPs). Some examples of conflicts of interest include:

- **Inherent:** Most secondary transactions are a transfer of assets from one GP-managed vehicle to another, effectively creating a situation where the GP is "selling" an asset in its role as fiduciary to existing LPs who are interested in exiting and selling their proportionate interests to the continuation fund. Simultaneously, the GP acts as a buyer by virtue of its role as fiduciary to the continuation fund and the new LP participants.

- **Prolong/Reset Economics:** GPs benefit economically from leading a secondary transaction. GPs benefit by extending the horizon of management fees they can receive. Also, GPs can reset the cost basis at a lower value and potentially crystallize carried interest.

- **Staple Deals:** To add to the web of conflicts, GPs may offer "stapled" co-investment opportunities for other funds managed by the GP as part of a secondary transaction. A stapled secondary is where an external LP purchases fund interests from current LPs, while also making a commitment to a new fund managed by the same GP.

To mitigate the potential impact of these various conflicts of interest, the SEC's new rules prohibit an advisor from completing a GP-led secondary transaction without first obtaining a fairness opinion or valuation report from an advisory firm that is independent.

## Fairness vs Valuation

So, what exactly is the difference between obtaining a "fairness opinion" versus a "valuation report" when it comes to GP-led secondaries? The technical difference between the two formats is subtle and the firms that provide fairness opinions frequently also provide portfolio valuation services and other transactional services. However, though valuation analyses are the core of a fairness opinion, the big distinction is that a fairness opinion addresses the fairness from a financial point of view to a party paying or receiving consideration in a transaction. A valuation report is a written opinion stating the value (either as a single amount or a range) of any assets being transacted.

Below is a summary of other considerations that differentiate a fairness opinion from a valuation report:

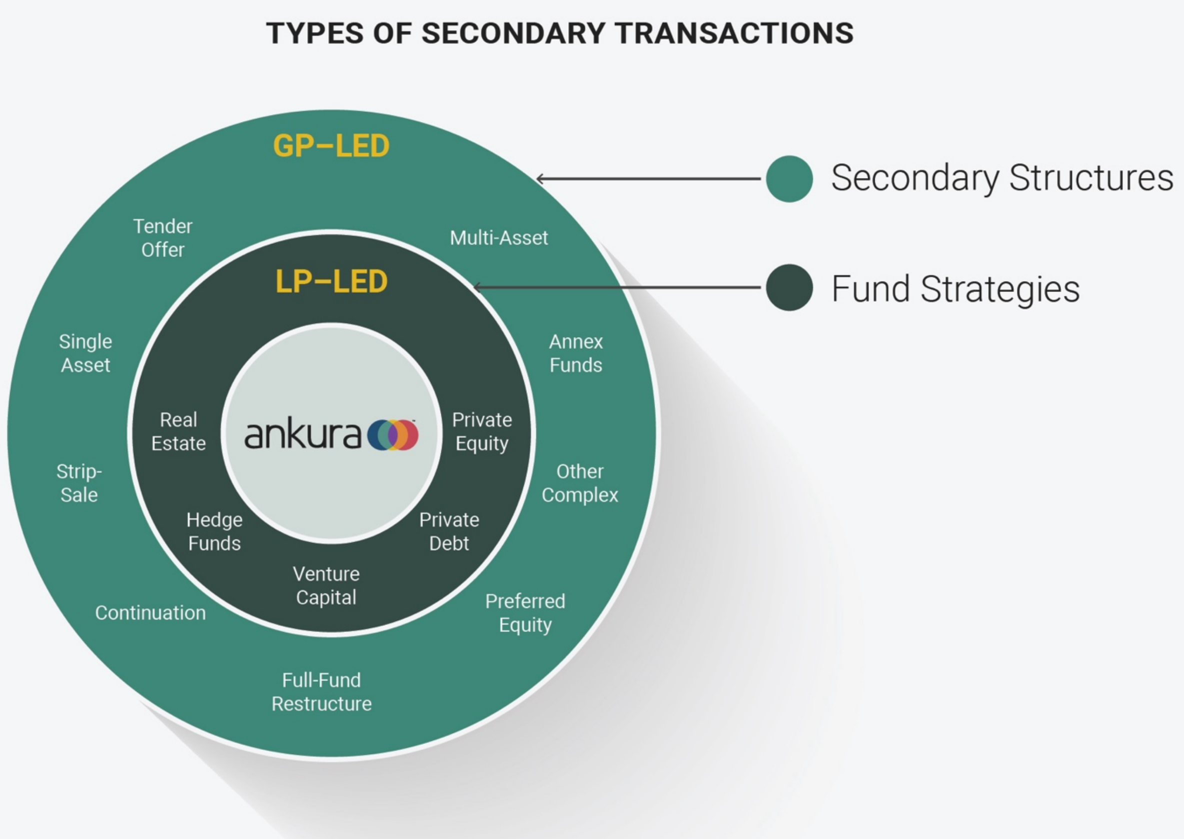
**COMPARISON OF SECONDARIES FAIRNESS OPINIONS VS. VALUATION REPORT**

| | KEY CONSIDERATIONS | FAIRNESS | VALUATION |
|---|---|---|---|
| CONTEXT | JURISDICTION | Potential implications depend on domicile, i.e., if Delaware or offshore. | No specific implications. |
| CONTEXT | FIDUCIARY RESPONSIBILITY | Potential implications related to duty of care, reasonable care, Business Judgement Rule, etc. | No specific implications outside of SEC requirements. |
| CONTEXT | CONFLICTS/FAIRNESS | Specifically addressed and mentioned in the opinion letter. | Does not address Conflicts/Fairness. |
| CONTEXT | DEFENSIBILITY | Higher standard and easier to defend. | Lower standard since does not address conflicts of interest (COI)/address fairness. |
| ANALYSIS | INDEPENDENCE | SEC mandated. Provides an independent market check. | SEC mandated. Provides an independent market check. |
| ANALYSIS | STANDARD OF VALUE ("SOV") | No specific standard is required. | Standards include FMV (IRS), FV (US GAAP/IFRS) and other |
| ANALYSIS | METHODOLOGY | Wide, flexible application of different approaches. | More stringent and proscribed methodology based on SOV) |
| ANALYSIS | DISCOUNT/PREMIUMS | Generally, discounts and premiums are not specifically required and are not consistently applied. | Based on SOV, could contemplate discounts or premiums as they pertain to marketability and control |

Whether you obtain a fairness opinion or a valuation report, the new SEC rule requires these reports to be issued only by an "independent opinion provider," which is defined as a firm that provides fairness opinions or valuation reports in the ordinary course of its business and is not a related party of the GP. The advisor is required to distribute the final deliverables to LP investors prior to the due date of the election form and must prepare and distribute a written summary of any material business relationships between the GP or its related persons and the independent advisory firm.

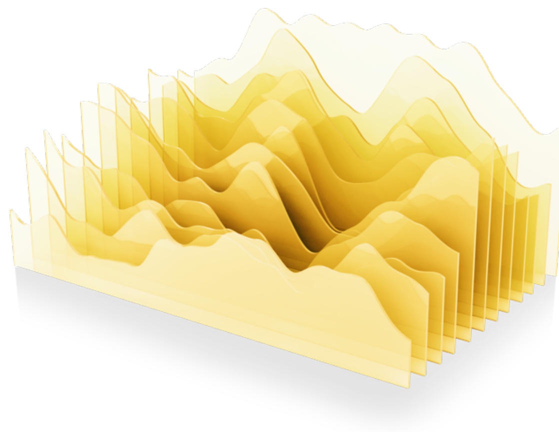
Ultimately, a fairness opinion addresses the fairness of the financial terms of a transaction, and not a certification of fact to support the transacted net asset value (NAV) price. This also applies to valuation reports. Since a fairness opinion is based on a mix of different valuation analyses, the reliability of a fairness opinion can rise or fall depending on the strength of the underlying valuation methods utilized. Another consideration is what compromises the underlying assets. More often than not, GP led secondaries pertain to private equity type investments (either single or multiple assets). However, there is a rising trend of secondaries for private debt, real-estate (debt and equity) and infrastructure funds. The financial adviser should be aware of the alternative valuation methods specifically related to these underlying assets, regardless of whether they are providing a fairness opinion or a valuation opinion.

## Secondary Transaction Overview



## Valuation Considerations

- Underlying Portfolio Composition/Diversification
- Fund Vintage
- Number of assets
  (portfolio companies/loan/properties etc)
- Capital Structure (at Fund/Asset Level)
- Market Checks/Auction
- Data Availability
- Prior 3rd Party Valuations
- Minority interests
- Liquidity Constraints
- Exit Strategies (Dual-Track, etc.)
- Geography



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