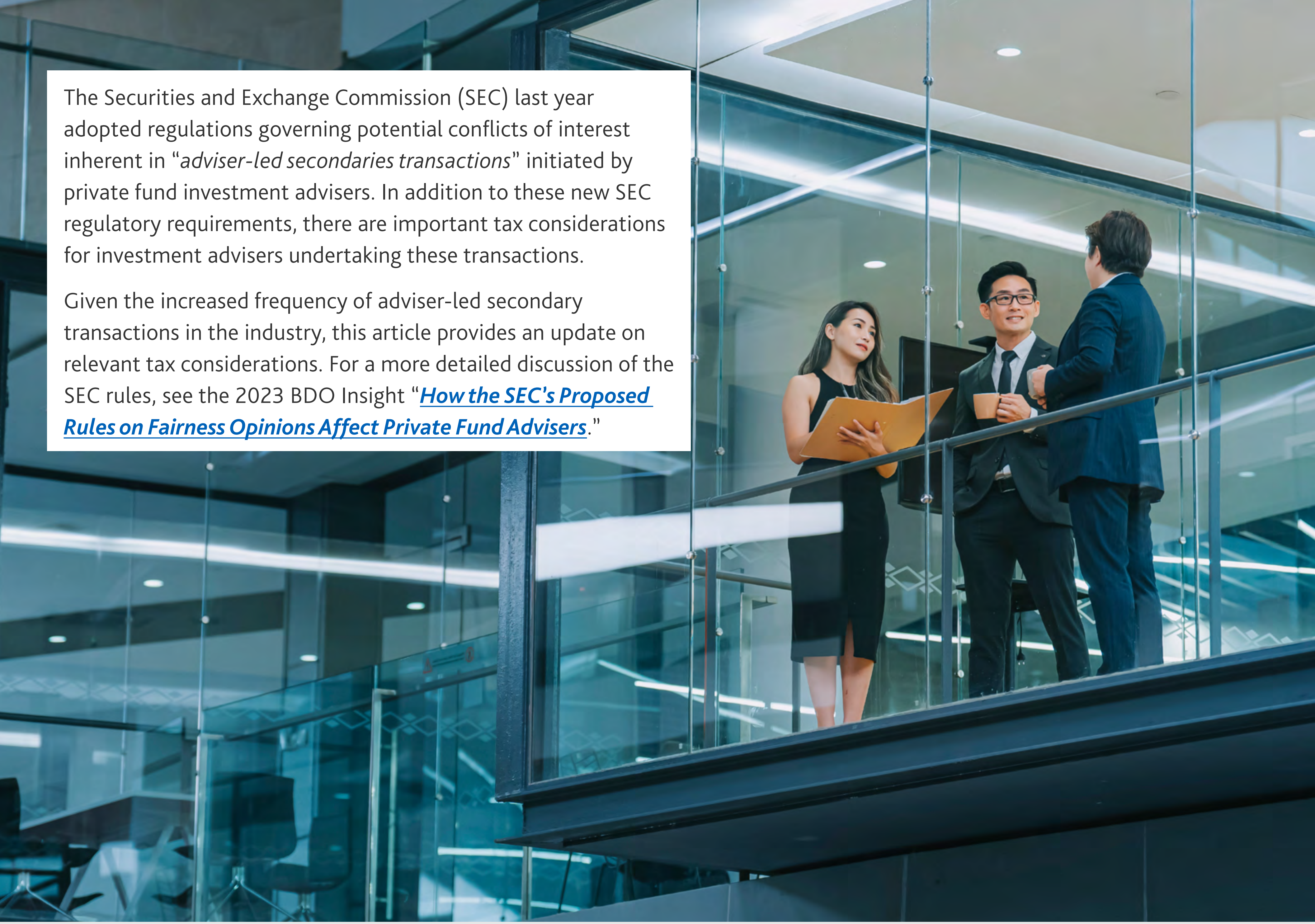
Private Fund 'Adviser-Led Secondary Transactions' and Related Tax Considerations

The Securities and Exchange Commission (SEC) last year adopted regulations governing potential conflicts of interest inherent in "*adviser-led secondaries transactions*" initiated by private fund investment advisers. In addition to these new SEC regulatory requirements, there are important tax considerations for investment advisers undertaking these transactions.

Given the increased frequency of adviser-led secondary transactions in the industry, this article provides an update on relevant tax considerations. For a more detailed discussion of the SEC rules, see the 2023 BDO Insight "***How the SEC's Proposed Rules on Fairness Opinions Affect Private Fund Advisers***."



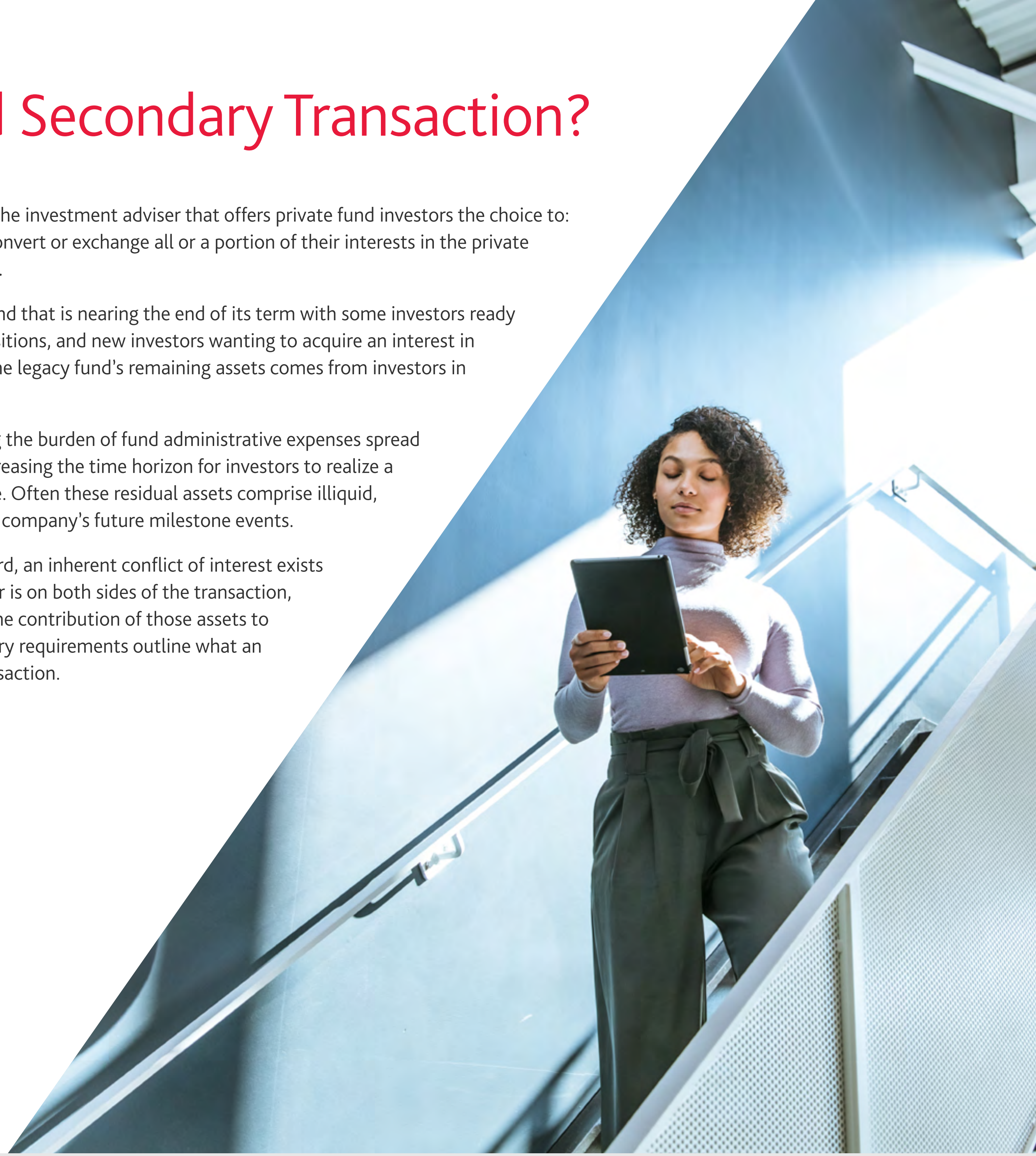
What is an Adviser-Led Secondary Transaction?

An "*adviser-led secondary transaction*" is a transaction initiated by the investment adviser that offers private fund investors the choice to: (1) sell all or a portion of their interests in the private fund; or (2) convert or exchange all or a portion of their interests in the private fund for interests in a new continuation fund formed by the adviser.

This type of transaction can be a good option for a manager of a fund that is nearing the end of its term with some investors ready to cash out, some looking to continue holding their investment positions, and new investors wanting to acquire an interest in the retained assets. Funding for the purchase and contribution of the legacy fund's remaining assets comes from investors in the continuation fund.

The benefits of adviser-led secondary transactions include reducing the burden of fund administrative expenses spread over a relatively small number of remaining residual assets and increasing the time horizon for investors to realize a liquidity event in assets that are expected to have continued upside. Often these residual assets comprise illiquid, contingent value rights whose value is dependent on an underlying company's future milestone events.

While adviser-led secondary transactions can appear straightforward, an inherent conflict of interest exists between the adviser and the investors, particularly since the adviser is on both sides of the transaction, which involves the purchase of assets from existing investors and the contribution of those assets to new and existing investors in a continuation fund. Specific regulatory requirements outline what an adviser must do prior to undertaking an adviser-led secondary transaction.



SEC Regulatory Requirements

Under final SEC rules adopted in August 2023 (SEC Rule 211(h)(2)-2), before soliciting investors to participate in an advisor-led transaction, the adviser must perform two exercises: (1) obtain a fairness opinion or independence valuation from an independent valuation specialist and (2) disclose any material business relationships between the adviser or related persons and the independent opinion provider.

FAIRNESS OPINION OR INDEPENDENT VALUATION FROM AN INDEPENDENT VALUATION SPECIALIST

The adviser must hire an outside valuation specialist to either render a fairness opinion on a pre-determined transaction value or to perform an independent third-party valuation. The differences between receiving a fairness opinion versus an independent valuation are worth highlighting. A fairness opinion specifically opines as to whether a specific price in a transaction is fair. Fairness opinions are narrowly focused in scope. If the opinion renders an unfavorable outcome, the provider is prohibited from advising the client on changing the terms of the transaction to arrive at a different outcome. An independent valuation establishes a valuation estimate, often in the form of a range. An independent valuation can provide involved parties with a range of valuation estimates upon which a reasonable transaction value can be arrived at.

DISCLOSURE OF MATERIAL RELATIONSHIPS

The adviser (and its related persons) must disclose any material business relationships it has had within the past two years with the independent valuation provider issuing the fairness opinion or independent valuation. This is intended to provide a level of transparency to the investor and attempts to uncover any inherent conflicts of interest before an adviser-led secondary is conducted.

Tax Considerations

In addition to the regulatory steps outlined above, there are several critical tax considerations that the adviser should address early in the process before embarking on the adviser-led secondary transaction. Planning well ahead of the transaction can help guide structuring of the deal and mitigate the risks of unintended results. Although there are many ways to effectuate an adviser-led secondary transaction, there are two key items an adviser should consider:

TAXABLE VS. TAX DEFERRED

Investors that elect to not participate in the continuation fund will typically have a taxable event upon their redemption. However, investors that elect to participate in the continuation fund may be able to do so in a tax-deferred manner. Commonly, rollovers of existing investors are structured in a tax-deferred manner, but the sponsor should give careful thought to the facts and circumstances of its fund, investors, and investments. Non-U.S. investors and U.S. tax-exempt investors may be indifferent as to whether the rollover is taxable or tax-deferred. U.S. taxable investors (for example, U.S. individuals, family offices, and general partner capital and carry interests) generally will be the most sensitive to tax considerations of the structure. Fund sponsors should understand these issues to identify which groups of investors would prefer a tax-deferred option and structure the transaction accordingly. When structuring to achieve tax deferral, the fund sponsor and its tax advisors will need to address issues such as tax basis and holding periods of the transferred assets and investors. Where the legacy fund holds portfolio companies eligible for the benefit of Qualified Small Business Stock (QSBS) treatment, the rollover may impact that tax status. Other tax considerations include whether the continuation fund inherits the legacy fund's other tax attributes, such as tax elections, IRS audit liabilities, accounting methods, and tax Identification number.

CARRY CONSIDERATIONS

A question that will arise during planning a continuation fund is whether the existing carry is "crystallized" (i.e., earned and payable). The portion of carry pertaining to investors that cash out will be crystallized. The portion pertaining to continuing investors may be crystallized depending on the economic arrangement of the continuation vehicle. If rollover investors are continuing the status quo of the old fund, then the pre-existing carry will likely not be crystallized. If instead carry is reset, then preexisting carry of the legacy fund would be crystallized and credited to the general partner's capital account. There are significant holding period considerations with respect to the carry as well as the portfolio investments that are transferred, since a three-year rule holding period rule applies under Internal Revenue Code Section 1061.

Conclusion

Adviser-led secondary transactions offer advisers and investors an option to avoid the costly, ongoing administrative burden of continually extending a legacy fund while, at the same time, maximizing the opportunity window for investors and advisers to realize a liquidity event in those residual fund assets. The increased use of evergreen and continuation fund structures has provided additional avenues to maximize the value of residual fund assets while avoiding the relatively stringent time limitations of a traditional fund structure.

In the context of compliance, it is important for registered investment advisers to understand and adhere to SEC Rule 211(h)(2)-2 to avoid conflicts of interest and protect the interests of their existing and new investors. Finally, careful consideration and planning around key tax issues generated by adviser-led secondary transactions are critical to maximize tax efficiencies and mitigate potential investor risks.

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CONTACT

STEVE CUNEO
Asset Management, Business Development / scuneo@bdo.com

DONNA LOBETE
Director, Valuation & Capital Market Analysis / dlobete@bdo.com

JOE PACELLO
Tax Managing Director, Core Tax / jpacello@bdo.com

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