Strelia PE Series | February 2025

Continuation Funds – The Double-Edged Sword of Opportunity and Conflict

Continuation funds have been a prominent feature of the GP-led secondary market in recent years. Although these transactions offer attractive opportunities, they also introduce significant complexities. With GPs participating on both sides of the deal, conflicts of interest inevitably arise and must be carefully managed.

What makes them so popular?

Continuation funds enable GPs to hold on to high-potential assets beyond the usual investment horizon (see our previous newsletter *Holding On To Diamonds Longer – Continuation Funds*) and maximize their value without selling these assets to a competitor—all while providing liquidity to investors. Existing LPs can either exit the continuation fund or have their interests rolled over to maintain exposure by reinvesting in the fund. Meanwhile, new investors gain access to mature, high-performing assets managed by a GP with a proven track record.

Addressing Conflicts of Interest Effectively

To ensure fairness and protect all stakeholders' interests when managing continuation funds, the following best practices are recommended. Some of these recommendations are based on the Limited Partners Association Guidelines from May 2023 which were adopted shortly after the US SEC's new rules concerning SEC-registered investment advisors.

- **Disclosure of conflicts:** GPs should identify and disclose any conflicts of interest related to the transaction process or its final economics. Potential conflicts may include diverging interests among LPs—based on their priorities and intentions regarding the assets—as well as issues such as the crystallization of carried interest, the method for soliciting bids on selected assets, and any economic incentives accruing to the GPs.
- **LP Advisory Committee (LPAC) consultation and consent**: GPs should consult with the fund's LPAC (if any) as early as possible, explaining the rationale for pursuing a continuation fund compared to alternative transactions. The LPAC should vote on whether to waive any conflicts. Governing documentation will often require the LPAC to approve the transaction.
- **Pricing:** The purchase price is typically determined by third parties, often through an auction process managed by a financial advisor to ensure fairness. GPs usually provide a fairness opinion or an independent third-party valuation to the existing LPs. In some cases—such as with partial disposals or hybrid co-invest arrangements—true external price validation may be challenging to achieve.
- **Terms:** Existing LPs who roll over their interests into a continuation fund should retain the benefits outlined in their original side letters as a baseline, even though certain provisions might not apply. Commercial terms should be evaluated on a case-by-case basis.
- **Transparency:** GPs should provide new investors with all material information necessary for informed decision-making regarding the transaction. This information should also be shared with existing LPs and, when appropriate, with the existing fund's advisory committee as early as possible.
- **Process and time**: GPs should engage advisors to facilitate the transaction and clearly disclose the terms of their engagement, specifying that these advisors act for the benefit of the fund—not the GPs. Moreover, existing LPs should be given sufficient time—typically at least 30 days—to evaluate the proposal and decide on their participation.

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