Focus Corporate Counsel/Securities

Unlocking the SEC's New Private Fund Adviser Rules

BY GRAHAM MCCALL

The SEC recently adopted sweeping and controversial new rules applicable to investment advisers to the $26.6 trillion private fund industry. While most of the substantive provisions of the Investment Advisers Act of 1940 apply only to registered investment advisers, several new rules also apply to certain managers and independent sponsors that file with the SEC as exempt reporting advisers.

The new rules are currently being challenged before the Fifth Circuit Court of Appeals. In the interim, private fund advisers should start preparing for thorny interpretive issues under the new rules—namely, those involving preferential treatment among investors.

It is common practice for private fund advisers to enter into "side letters" or other similar agreements with certain investors. These side letters and agreements may provide those investors with favorable rights under the private fund's governing agreement. Side letters are particularly common for "seed" deals, in which an investor provides initial capital to a private fund and, in exchange, receives reduced fees, better liquidity, or enhanced transparency (among other things) from the fund. Under the SEC's new rules, certain prohibitions and notice requirements will apply to these arrangements, regardless of a private fund adviser's registration status.

Preferential Redemption Rights

Subject to certain limited exceptions, the new rules prohibit investors from receiving preferential rights (i) to redeem their interests prior to or on better terms than other investors in the same fund or a similar pool of assets, or (ii) to receive information regarding the portfolio holdings or exposures of the private fund or a similar pool of assets that other investors do not receive.

Notice of Preferential Treatment

Prospective investors must receive notice if another investor in the same fund has been granted preferential treatment on any material economic terms of the investment (e.g., fee breaks and co-investment rights). Current investors must receive written disclosures of all preferential treatment granted to other investors in the same fund. For an illiquid private fund (e.g., a private equity fund), these disclosures must be provided upon completion of the fundraising period. For a liquid private fund (e.g., a hedge fund), the disclosures must be provided as soon as reasonably practicable after the investor makes his or her investment. All investors in a private fund must receive annual written notice regarding any preferential treatment provided during the preceding year.

Treatment of Existing Funds

Private fund advisers should determine which existing private funds and side letters fall within the scope of the new rules' preferential treatment prohibitions and notice requirements. Preferential liquidity and transparency rights for side letters dated prior to the applicable compliance deadline (likely third quarter of 2024, at the earliest) will generally be granted legacy status. Even then, fund advisers will still need to disclose the preferential terms to all investors by the new rules' compliance deadline.

For liquid funds, investors may continue to be given different liquidity options through different classes of interests. But investment size can no longer be a gating criteria. Rather, the trade-off may be that a fund provides investors with greater liquidity rights in exchange for higher fees.

Similar Pools of Assets

While private fund advisers need not disclose to a particular fund's investors whether preferential treatment is provided to investors in a similar pool of assets, they still must consider those similar pools of assets for purposes of the prohibition against preferential liquidity and transparency rights.

The rules define a "similar pool of assets" to generally mean a pooled investment vehicle (other than a registered fund or securitized asset fund) with substantially similar investment policies, objectives, or strategies to those of the private fund managed by the adviser or its related persons. This definition is vague and raises a number of questions: Does this definition require that a co-investment vehicle not give investors greater transparency into the underlying asset than is given to investors in the main fund? When can a fund-of-one for a larger institutional investor be considered within the definition's scope? Would any of the adviser's proprietary vehicles meet the definition such that insiders would no longer be able to redeem sooner or have greater insight into certain holdings?

Outside counsel will need to grapple with these questions to ensure private fund adviser clients do not inadvertently violate the new rules. **HN**

Graham McCall is a Partner at Jackson Walker. He can be reached at gmccall@jw.com.

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Chair, DBA Health Law (2021)
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Martin@MartinMerritt.com | Dir. (214) 952.1279

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Sylvia Demarest and Edward Cloutman Win 2024 MLK Justice Award

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Cloutman when he was only a second-year attorney seeking help—he wanted his children, who lived just down the road from a white school near Love Field, not to have to take the bus to a black school in West Dallas. Demarest and Cloutman would spend the next several years of their lives fighting to end the segregation of Dallas public schools not only on paper but in practice. Collectively, they put almost 1,700 hours into that single case, resulting in the resounding vindication of the educational rights of children of color.

Demarest and Cloutman, as lawyers, as citizens, and as leaders, embody the ideals that Dr. King called each of us to aspire to. They did their part to bend the moral arc of the universe towards justice, and it is only fitting that they be recognized as the recipients of this year's DBA MLK Justice Awards. **HN**

J. Collin Spring is an Associate at Ryan Law Firm, PLLC, and a Co-Vice Chair of the DBA's Publications Committee. He may be reached at jay.spring@ryanlawyers.com.

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