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The SEC's Private Fund Adviser Rules Explained

Part 2: The Preferential Treatment Rule

By Scott H. Moss, David L. Goret, Jeremy Cantor, Zachary D. Furnald, and Michael J. Scales

On August 23, 2023, the U.S. Securities and Exchange Commission (SEC) adopted new and amended rules under the Investment Advisers Act of 1940, as amended (the Advisers Act), to address certain conflicts of interest and promote investor protection in the private funds industry (the Private Fund Adviser Rules).[1] We recently released a Client Alert providing an overview of the Private Fund Adviser Rules and a Client Alert addressing one of those rules, Rule 211(h)(2)-1 (the Restricted Activities Rule), which limits the ability of advisers to private funds regardless of whether they are registered as investment advisers with the SEC or one or more states or exempt from such registrations (private fund advisers) to engage in certain practices. This Client Alert addresses another of the Private Fund Adviser Rules, Rule 211(h)(2)-3 (the Preferential Treatment Rule), which prohibits private fund advisers from (i) providing certain preferential redemption and transparency terms to select fund investors, subject to certain exceptions, and (ii) giving preferential treatment to select fund investors unless the private fund adviser satisfies certain disclosure obligations to current and prospective fund investors.

Overview of the Preferential Treatment Rule

In its proposed rules issued in February 2022, the SEC had proposed to prohibit private fund advisers from (i) granting certain preferential redemption terms or (ii) providing certain preferential information to investors in the private fund or in a substantially similar pool of assets if the private fund adviser *reasonably expects* doing so would have a *material, negative effect* on other investors in the fund or such pool (which we explain further below). At that time, the SEC had also proposed to require private fund advisers to disclose to prospective and current fund investors certain specific information about any preferential treatment the private fund advisers or their related persons were providing to other investors in the fund. The SEC ultimately adopted the prohibitions and disclosure requirements generally consistent with the proposed rules, but with certain exceptions and modifications, as described in detail below. Importantly, the Preferential Treatment Rule does not apply to (x) private fund advisers with respect to securitized asset funds they advise or (y) private fund advisers whose principal place of business is outside the U.S. with respect to offshore funds they advise, even if such offshore funds have U.S. investors.

Prohibited Preferential Redemptions

Consistent with the proposed rule, the Preferential Treatment Rule will prohibit a private fund adviser from granting an investor in a private fund it advises or in a *similar* pool of assets the ability to redeem its interest on terms the private fund adviser *reasonably expects* would have a *material, negative effect* on other investors in such fund or similar pool of assets. But in a departure from the proposed rule, the prohibition, as adopted, will not apply if (i) the investor is required by "applicable laws, rules, regulations, or orders of any relevant foreign or U.S. Government, State, or political subdivision to which the investor, the private fund, or any similar pool of assets is subject" to have that redemption ability;[2] or (ii) the private fund adviser has offered the same redemption right to all other existing investors[3] and will continue to offer that ability to all future investors in the fund or any similar pool of assets (i.e., explicitly in the fund documents).[4] As with other rules under the Advisers Act, private fund advisers are prohibited from doing indirectly what they may not do directly.[5] The prohibition on preferential redemption rights addresses the SEC's concern that private fund advisers may benefit from granting preferential liquidity rights to certain investors, especially larger investors, to induce them to

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[1] The SEC's adopting release setting forth the Private Fund Adviser Rules is available here.
[2] Note the SEC explicitly clarified that this carve-out does not apply to "informal arrangements [of such investor], such as policies and resolutions."
[3] While not stated in the Preferential Treatment Rule itself, the SEC clarifies in the adopting release that the latter exception requires the private fund adviser to offer the redemption ability to all future investors *without qualification*, e.g., the adviser cannot limit the redemption terms based on commitment size, affiliation, or another basis.
[4] Subject to the "material, negative effect" analysis we discuss later, the SEC noted this would apply to, e.g., "friends and family" classes.
[5] An example the SEC provides is "offering" all the different share classes (some of which have more preferential redemption rights than others) in the fund documents, while only accepting investors into certain preferential redemption classes if they invest in a different fund managed by the private fund adviser.

invest (and hence, increase the private fund advisers' assets under management and fees), but in a way that materially negatively impacts other investors. The SEC carved out the two bona fide exceptions, however, in recognition that some investors are required by law to obtain preferential liquidity terms and also to preserve investor choice regarding liquidity and price.

Prohibited Preferential Transparency

Consistent with the proposed rule, the Preferential Treatment Rule will also prohibit a private fund adviser from providing information[6] regarding the portfolio holdings or exposures of the private fund or of a *similar* pool of assets to any investor in the fund if the private fund adviser *reasonably expects* that providing the information would have a *material, negative effect* on other investors in the fund or pool. But, as adopted, the prohibition under the rule will not apply if the private fund adviser also offers that information to all other existing investors in the fund and any similar pool of assets at substantially the same time. This prohibition is intended to address the SEC's concern that selective disclosure of portfolio information may entitle those investors to asymmetric portfolio information to profit or avoid losses at the expense of other investors who did not have the benefit of this enhanced transparency. But the exception recognizes that this concern is negated if all other investors also have that information.

'Similar Pool of Assets'

The term "similar pool of assets" is relevant to the prohibitions discussed in the two immediately preceding paragraphs. The rule defines the term to mean a pooled investment vehicle (other than an investment company registered under the Investment Company Act of 1940, a company electing to be regulated as such, or a securitized asset fund) with substantially similar investment policies, objectives, or strategies to those of the private fund managed by the private fund adviser or its related persons. The adopting release implies the term should be interpreted broadly and will encompass a variety of pools, regardless of whether they are private funds. The SEC included this term to prevent private fund advisers from structuring around the rule's prohibitions by, among other things, creating custom feeder funds for preferred investors and providing the (banned) preferential redemption abilities and preferred rights to information to investors via such feeder funds.

'Reasonably Expects'

With respect to the redemption and transparency prongs of the Preferential Treatment Rule, a private fund adviser is prohibited from providing such terms (subject to the exclusions discussed above) *if* such private fund adviser *reasonably expects* that providing the terms would have a *material, negative effect* on other investors in the fund or pool.

The adopting release offers limited meaningful discussion of what the SEC considers "material." But with respect to the "reasonably expects" standard, the SEC notes the following:

- It is an objective standard that takes into account what the private fund adviser reasonably expected at the time.
- The standard requires private fund advisers to form only a reasonable expectation based on the facts and circumstances.
- A private fund adviser's actions will be judged based on the facts and circumstances at the time it grants or provides the preferential treatment.

Notwithstanding the expressed guidance in the rule release, we caution private fund advisers that the SEC often views events in hindsight. For that reason, private fund advisers may be well served by contemporaneously documenting their determinations that an otherwise prohibited grant of rights under the rule did not have a material, negative effect on other investors.

Other Preferential Treatment and Disclosure Requirements

The Preferential Treatment Rule, as adopted, will also prohibit private fund advisers from providing *any* preferential treatment to any investor in the private fund unless the private fund adviser provides certain written notices to prospective and current investors in the fund.

First, generally consistent with the proposed rule, private fund advisers must provide to each *prospective* investor in a fund, prior to the investor's investment, a written notice that includes specific information about any preferential treatment concerning any material economic terms[7] that the private fund adviser or its related persons provide to any other investor(s) in the fund. Notably, and in a departure from the proposed rule, the information would be limited to preferential treatment "related to any material economic terms" (as opposed to any preferential treatment altogether).

Second, private fund advisers must distribute to each current investor in a fund *written* disclosure[8] of all preferential treatment the private fund adviser and its related persons have provided to other investors in the fund. The disclosure must be made as soon as reasonably practicable[9] following (i) the end of the fund's fundraising period (for illiquid funds), or (ii) the investor's investment in the fund (for liquid funds). This "as soon as reasonably practicable" disclosure requirement is new and did not appear in the proposed version of the rule. However, consistent with the

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[6] It is important to note that this part of the Preferential Treatment Rule does not apply only to side letter terms. The SEC explicitly notes that the rule applies to "all types of communications: formal and informal as well as written, visual, and oral."
[7] The SEC notes, for example, "the cost of investing, liquidity rights, fee breaks, and co-investment rights."
[8] The SEC notes that this can be done by either (a) providing copies of side letters (which the adviser can redact) or (b) providing a written summary of the preferential terms provided to other investors in the same private fund, provided the summary specifically describes the preferential treatment.
[9] The SEC notes that while what is "as soon as reasonably practicable" will depend on the facts and circumstances, "it would generally be appropriate for advisers to distribute the notices within four weeks."

proposed rule, private fund advisers must, on at least an annual basis, distribute a written notice to each *current* fund investor that discloses specific information regarding any preferential treatment the private fund adviser and its related persons have provided to other investors in the fund since the last written notice it provided per this disclosure requirement. Importantly, disclosure would be required where the private fund adviser provides preferential information to a transferee in connection with an investor transfer during the period. It also appears that renewed disclosure obligations could be triggered upon additional capital raising over the life of the fund.

The SEC reasons that the disclosures described above address its concern that private fund advisers' current practices do not provide all investors with meaningful information regarding preferential terms granted to other investors. The SEC reasons that these disclosures will help investors understand whether, and how, such terms present conflicts of interest and will help prevent investors from being potentially defrauded or deceived as a result of preferential treatment, of which they were unaware, that was given to other investors and that negatively impacts their investment in the fund.

Related Recordkeeping Requirements

The SEC also adopted companion amendments to Rule 204-2 under the Advisers Act, which are applicable to private fund advisers registered with the SEC. These amendments will require such private fund advisers to retain copies of all written notices sent to current and prospective investors pursuant to the Preferential Treatment Rule. They must also retain a record of each addressee and the corresponding dates when the distributions were sent.

Legacy Status

The SEC has granted legacy status with respect to the prohibitions aspect of the Preferential Treatment Rule (i.e., subparagraph (a) of Rule 211(h)(2)-3 regarding prohibitions against granting certain preferential redemption abilities and providing certain preferential information to investors). As a result of this legacy status, these prohibitions will not apply with respect to *contractual agreements*[10] (i) governing a private fund that has commenced operations as of the compliance date, (ii) agreed to in writing prior to the compliance date, and (iii) if compliance with the rule would require the parties to amend such agreements. Importantly, legacy status will not apply to the rule's disclosure requirements, presumably because the incremental disclosure will benefit investors generally and will not require existing agreements to be modified.

Our Thoughts

The Private Fund Adviser Rules, including the Preferential Treatment Rule, represent a sea change in the regulatory landscape for private fund advisers. For that reason, private fund advisers should adopt a comprehensive strategy for identifying all instances in which select investors have been granted preferential redemption rights and/or enhanced access to portfolio information, or other preferential rights covered by the rule. While these preferential arrangements are often effected and documented through side letter agreements, private fund advisers should nevertheless review other fund documentation and even informal correspondence with investors in order to identify rights that are now prohibited under the rules. The scope of the prohibitions is broad, so private fund advisers should consider that even terms such as reduced notice requirements for redemption, information provided to existing investors on a limited partner advisory committee, or responses to unsolicited investor requests or due diligence requests could constitute preferential liquidity or transparency under the rule. Private fund advisers would be well advised to update their compliance policies and procedures to flag the various types of preferential arrangements prohibited by the rule so they can either avoid making those arrangements or, where appropriate, make those arrangements in a way that meets the exceptions and otherwise complies with the relevant rule provision(s). Private fund advisers should also take note of the methods by which they typically grant preferential rights with respect to redemption and transparency to ensure that compliance policies and procedures are consistently applied and reviewed when engaging and negotiating with investors.

Private fund advisers should adopt policies and procedures to identify situations that would trigger application of the "material, negative effect" standard associated with the prohibitions under the rule. As discussed above, the general prohibitions on granting investors certain preferential redemption abilities and information apply only when the private fund adviser *reasonably expects* that doing so would have a *material, negative effect* on other investors in the fund or a similar pool of assets. The adopting release provides some color regarding what might constitute a material, negative effect on investors. In highlighting its concerns underlying the rule's prohibitions, the SEC posits that granting an investor preferable redemption rights could allow the investor to exit the fund early and possibly require the private fund adviser to sell liquid assets to accommodate the exiting investor's redemption. Other investors could be adversely impacted either because the fund was not able to sell at an optimal price or because the fund will hold fewer liquid assets, which could impair the fund's ability to carry out its investment strategy or satisfy the redemption requests of other investors. Similarly, the SEC posits that selectively disclosing information regarding portfolio holdings or exposures to an investor could result in the "favored" investor making profits or avoiding losses at the expense of other investors, or could enable such an investor to trade in a way that "front runs" the fund. Since open-ended funds are more likely than closed-end funds to provide investors with redemption rights and opportunities to act on preferential transparency, we believe (and the SEC appears to acknowledge) that a material, negative effect will be less likely to occur in closed-end funds. In that vein, the SEC indeed notes

[10] It is important to note that the SEC *explicitly* noted that legacy status applies only to contractual agreements (such as partnership agreements and side letters). It does *not* apply to noncontractual agreements such as, for example, oral/handshake agreements.

that granting preferential transparency to an investor in an illiquid fund would generally not have a material, negative effect on other investors since the investor would be limited in its ability to act on that information. That said, the SEC explicitly did not carve out illiquid funds from these requirements. Taken together, the SEC's commentary makes clear that the determination of whether providing the preferential arrangement will have a material, negative effect on other investors is, in all cases, a facts and circumstances analysis. Private fund advisers should adopt policies and procedures that take into account the relevant features of the fund and its investors in assessing the impact of a proposed preferential arrangement.

When preparing to comply with the rule's written disclosure requirements, private fund advisers should also consider the impact these requirements may have on their negotiation of side letters. Since prospective fund investors must be given notice of preferential treatment concerning material economic terms provided to select fund investors *prior* to the prospective investors' investments, side letters may need to be negotiated earlier to ensure any relevant terms can be timely disclosed. Additionally, private fund advisers to illiquid funds should be aware of their disclosure obligations to current investors at the time of the relevant compliance date. Even if the fund's final closing has occurred as of the relevant compliance date, we believe the SEC could interpret the requirement to make disclosures "as soon as reasonably practicable" following the end of the fund's fundraising period to require that disclosures be made on the compliance date.

As discussed above, any agreements on preferential redemptions or transparency must be in writing to qualify for legacy status. Moreover, the legacy status (and accommodations) afforded by the rule will apply only with respect to the rule's prohibitions and not to its disclosure requirements. As a result, preferential treatment afforded to investors in private funds will need to be disclosed to the other investors in the fund as of the compliance date. This means that certain privately negotiated terms of side letters entered into before the compliance date will need to be disclosed to investors generally. While the terms will need to be disclosed, the SEC stated that private fund advisers need not disclose the identity of the preferred investors. It remains to be seen, and the SEC has not mandated, the manner or format in which private fund advisers will go about making this sensitive disclosure. The adopting release recognizes private fund advisers may disclose the preferential terms simply by providing copies of redacted side letters or by summarizing the preferential terms provided to other investors so long as the summary "specifically describes" the relevant terms. We expect that market practices may vary until a perceived best practice emerges. While private fund advisers should make efforts to provide sufficient specificity and clarity in order to satisfy the SEC mandate, they should also be careful to disclose only that information that is strictly required under the rules. While the disclosure can be anonymized, as a practical matter, private fund advisers will still need to be mindful of how "rank and file" investors will react to the disclosure of the preferential terms afforded to select investors.

Next Steps

The SEC is adopting staggered compliance dates for the Preferential Treatment Rule that provide for the following transition periods. Private fund advisers with $1.5 billion or more in private fund assets under management must comply within 12 months after publication of the Preferential Treatment Rule in the Federal Register (September 14, 2024), while those with less than $1.5 billion in private fund assets under management must comply within 18 months after publication (March 14, 2025). We encourage private fund advisers to review all relevant documents, including side letter agreements, and their compliance policies and procedures in order to comply with the applicable provisions and disclosure requirements within the relevant transition period.

Please contact one of the listed authors of this Client Alert or your regular Lowenstein Sandler contact if you have any questions regarding this rule.

Contacts

Please contact the listed attorneys for further information on the matters discussed herein.

SCOTT H. MOSS
Partner
Chair, Fund Regulatory & Compliance
T: **646.414.6874**
smoss@lowenstein.com

DAVID L. GORET
Partner
T: **646.414.6837**
dgoret@lowenstein.com

JEREMY CANTOR
Associate
T: **212.419.5986**
jcantor@lowenstein.com

ZACHARY D. FURNALD
Associate
T: **862.926.2791**
zfurnald@lowenstein.com

MICHAEL J. SCALES
Associate
T: **973.422.6770**
mscales@lowenstein.com

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