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Regulatory Focus on Investor Side Letters

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Side letters are an important component of most fund finance deals. They are reviewed by lenders in connection with due diligence reviews (i) for subscription line facilities to determine the rights and obligations of investors in respect of capital commitment collateral and (ii) for NAV facilities to determine the liquidity and information rights attached to equity interest collateral. The SEC is expected to revert shortly on a proposed rule published last year that, if adopted, could impact the substance of side letters. That proposal received extensive feedback from fund managers, investors, industry groups and other market participants. Below we have discussed certain aspects of the proposed rule. We note that this is merely a proposed rule, and the contours of what will be included in the final rule are unclear.

Side letters are a common way of formalizing bilateral negotiated arrangements between a private fund and its investors, where investors seek to modify the rights and entitlements generally applicable to investors pursuant to the fund's constituent documents. Side letters can address a myriad of issues but often include provisions reducing investment management or performance fees, granting fee rebates, providing excuses for funding capital, granting preferential liquidity and redemption terms (*e.g.*, waiving lock-up provisions or offering shorter redemption notice periods) or providing for enhanced transparency and reporting. In the private fund space, side letters have been a hotly debated topic for decades. By entering into side letters with preferential terms, fund managers worry about breaching fiduciary duties obliging them to treat their clients fairly. Historically, to mitigate the risk of such claims, fund managers have included in offering materials or constituent documents of the funds they manage disclosure language noting that the fund and/or manager may enter into side letters that result in different investment terms applying to certain investors.

On February 9, 2022 the SEC proposed a number of significant new and amended rules under the Investment Advisers Act of 1940 focusing on private fund advisers. The public comment period for the proposal closed on June 13, 2022, and the SEC is expected to take final action on the rule in early 2023. The proposed rules are designed to enhance transparency and prohibit conflicts of interest. The rules cover a lot of ground and include enhanced quarterly reporting and annual audit requirements, prohibitions on certain fees and expenses, prohibition on certain provisions seeking indemnification, limited liability or clawback of carried interest net of taxes, prohibition on borrowing from private fund clients, and certain requirements for adviser-led secondaries. Among the proposed rules is a prohibition on investment advisers offering certain types of preferential liquidity and preferential information rights to a sub-set of investors if such differences would be expected to have a material, negative effect on certain investors. The proposal would also require investment advisers to disclose in detail other types of preferential terms being given to a subset of investors.

The preferential treatment rule, if adopted, could force private fund advisers to re-evaluate their practices, including the practice of having differing liquidity and information terms apply to fund investors. It could also prompt them to reconsider the level and type of disclosure they provide with respect to variance in investment terms.

Market participants have also raised concerns that the rule may create challenges for both fund advisers and investors. For example:

- Side letters are an essential tool used by institutional investors to ensure compliance with statutory, regulatory or governance protections. There is no carve-out under the proposed rule for investors that need to negotiate preferential withdrawal rights in order to comply with regulatory or statutory requirements.
- Certain investors (*e.g.*, many public pension plans) may need the flexibility to divest when required to comply with internal portfolio concentration or other risk limits. Having different liquidity or transfer rights allow them to invest in less liquid investments in a manner that complies with such internal limits.

- Side letters are often used to incentivize seed or anchor investors to provide capital to support investment while the fund adviser continues to raise capital from external investors. This is particularly important for smaller and newly formed advisers and may create a significant barrier to entry into the market.
- The prohibition on preferential treatment regarding information rights could chill investments in private funds, and may have broader social impact. Not only will enhanced transparency impact investors who require a look-through analysis for their own risk management purposes or to meet their obligations under state or local law, but the prohibition could have broader implications for investors' general due diligence. The proposed rule could limit access to information by investors looking to promote diversity, equity and inclusion and/or environmental, social and governance investing.

Institutional advisers have raised objections that the proposed rule effectively regulates negotiations between private fund sponsors and private fund investors, and that such regulation is unnecessary as private fund investors tend to be highly sophisticated and well represented. Numerous comments from large, institutional, industry groups and law firms cited concerns that the lack of clarity as to what constitutes "preferential treatment," "reasonable belief" or "material, negative effect" make the proposed rule overbroad and difficult to implement, and likely to have a chilling effect on investors in private funds, including large, institutional investors. In addition, they have argued that the proposed rules, as written, could restrict competition, cause industry consolidation, deter new, entrepreneurial advisers from entering the market and limit an investor's ability to adequately due diligence its investment opportunities in private funds.

The final rule may differ materially from the proposed rule. Stay tuned for further updates once the final rule is published.