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Contributing Editor:
Wes Misson
Cadwalader, Wickersham & Taft LLP

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Introduction

The asset management industry is in a period of rapid evolution. Historically, private equity has only been available to large institutional investors and certain high-net-worth individuals. However, increasingly, sponsors are developing creative solutions to bring private equity, private credit and other alternative asset classes to a broader audience by relying on certain regulatory exemptions under the Investment Company Act of 1940 (the "*1940 Act*") or electing to launch regulated products. These new fund structures may be subject to differing regulatory restrictions, depending on their investor base, investment strategy and liquidity profile. For purposes of this chapter, we will refer to such investment structures as "Regulated Funds".

In past decades, the prototypical private fund has only been accessible to institutional investors, such as endowments, pension funds, and ultra-high-net-worth individuals, each of which can allocate millions of dollars to a single investment without realising any meaningful return for an extended period of time. Investors in a private fund ordinarily cannot redeem their investment at will; rather, they may sell their investment on the secondary market, or else must wait until the fund returns capital, together with any investment gains, over several years.

In contrast, many registered funds, such as open-end mutual funds, closed-end funds, interval funds, and exchange-traded funds, as well as business development companies ("*BDCs*"), which are regulated under the 1940 Act, are open to all types of investors. Most categories of registered funds are continuously offered and receive cash investments without a drawdown mechanic, and each category offers liquidity to its investors through a different method. Due to a registered fund's constant inflows and outflows and the strict regulatory requirements of the 1940 Act, registered fund managers were previously unable to pursue the alternative investment strategies that were common among private fund managers.

While the asset management industry used to be neatly divided between private funds and registered funds, new fund structures have blurred that distinction, as they offer alternative investment strategies through Regulated Funds that raise money continuously and provide reoccurring opportunities for liquidity. One such structure is an evergreen "private" fund, which relies on the regulatory exemption under Section 3(c)(7) of the 1940 Act, but is offered to investors on a continuous basis and provides periodic liquidity to investors. This product sits somewhere between a traditional private fund and a

retail fund, as it can make investments without a drawdown mechanic and offer periodic liquidity pursuant to tender offers. In addition, such funds can be registered under the Securities and Exchange Act of 1934, as amended (the "*Exchange Act*"), and by filing Forms 10-K, 10-Q and 8-K, they provide more transparency than a typical "private" fund. Another example is a privately offered, non-traded BDC that is usually offered through a series of closings in a manner similar to a traditional private fund, but is subject to regulatory limits on leverage and may provide liquidity to investors via periodic tender offers.

As described more fully below, fund sponsors have developed various Regulated Fund products that increase access to alternative investments. This recent proliferation of Regulated Funds has created new opportunities and challenges for fund finance professionals. Many of the rules applicable to Regulated Funds will be unfamiliar to fund managers that previously focused on private investment vehicles intended for institutional investors. In addition, the financing strategies that have traditionally been relied upon by private funds must be reconsidered when applied to Regulated Funds.

Private funds and the 1940 Act

To better appreciate the next generation of Regulated Funds, it is critical to understand the regulatory background and how Regulated Funds differ from their predecessors. As a baseline, an issuer can be exempt from the definition of "investment company" under the 1940 Act or from registering under the 1940 Act if it meets certain requirements set forth in Section 3(b) or 3(c) of the 1940 Act and exemptive rules under the 1940 Act, or if the Securities and Exchange Commission (the "*SEC*") grants an exemptive order to the issuer. If an issuer meets the definition of "investment company" and does not fall within an exclusion, it must register with the SEC as an investment company, and the 1940 Act's regulatory framework will apply to the fund and its operations.

In the modern asset management industry, private funds generally rely on Section 3(c)(7) of the 1940 Act, which permits an issuer to raise an unlimited amount of capital if it does not make a public offering of its securities and its securities are owned exclusively by "qualified purchasers". Qualified purchasers are natural persons with at least $5 million in investments and institutional investors with at least $25 million in investments. Another common exemption is Section 3(c)(5)(C) of the 1940 Act, which is available to any issuer that is primarily engaged in the business of purchasing or otherwise acquiring mortgages and other liens on and interests in real estate. Historically, if a fund sponsor wished to offer a pooled investment vehicle to a wide population of investors in a continuous offering, it would consider registering the vehicle as an investment company under the 1940 Act or electing to be regulated as a BDC under the 1940 Act. However, the newest forms of Regulated Funds have altered that model.

Types of Regulated Funds

At a very high level, the most prevalent Regulated Fund structures in the marketplace today can be grouped into the following categories:

(1) *registered investment companies* that are subject to the full 1940 Act regulatory framework (such as traditional closed-end funds, open-end funds and interval funds);

(2) *BDCs*, which do not register as investment companies, but elect to be regulated under the 1940 Act and are therefore subject to many of the substantive provisions of the 1940 Act; and

(3) *publicly registered, evergreen "private" funds*, which are offered to qualified purchasers under the Section 3(c)(7) exemption.

Registered investment companies

Registered investment companies are subject to the full set of rules imposed by the 1940 Act, including strict requirements related to transactions with affiliates, use of leverage, fees and compensation, compliance oversight, public reporting, and board governance, among others. Registered investment

companies can be broadly described as either (i) open-end funds, which allow investors to redeem their interests in a fund at net asset value ("*NAV*") on a daily basis (i.e., mutual funds), or (ii) closed-end funds, which do not offer daily liquidity to their investors. Due to the liquidity profile of alternative investment strategies such as private equity, real estate, and private credit, most of the new generation of registered investment companies are structured as closed-end funds, rather than open-end funds.

Registered investment companies that are closed-end funds generally offer investors liquidity through periodic tender offers or by listing their securities on an exchange. Because investors in listed closed-end funds can sell their shares on an exchange, such funds are not ordinarily designed to offer to repurchase investors' shares. However, a closed-end fund that is not listed on an exchange typically operates a discretionary tender offer programme that is governed by the fund's board. While tender offer funds are not required by the 1940 Act to repurchase their shares, most fund sponsors find that investors expect an unlisted closed-end fund to offer to repurchase up to 5% of the fund's NAV on a quarterly basis.

Another type of registered investment company structure is the interval fund, which is governed by Rule 23c-3 under the 1940 Act and must offer to repurchase between 5 and 25% of its NAV at regular intervals of every three, six, or 12 months. An interval fund's repurchase percentage is set by the fund's board as a fundamental policy that cannot be changed except by shareholder vote. Similar to tender offer funds, most interval funds repurchase up to 5% of the fund at NAV on a quarterly basis, though some sponsors seek relief from the SEC to offer monthly repurchases.

Of particular importance to fund finance professionals is that all of the categories of registered investment companies described above are required to maintain a leverage ratio of at least $2 in equity for each dollar of debt (i.e., a 1:2 debt to equity ratio). Additionally, any registered investment company can generally only have one class of debt. Broadly speaking, debt will be considered a single class if it is the same level of priority and same type. For example, a registered investment company cannot simultaneously have an unsecured credit facility and a secured credit facility, nor can it have a credit facility with subordinated tranches. Additionally, registered closed-end funds may only issue one class of preferred stock and are subject to a 1:1 debt to equity leverage limit with respect to the issuance of preferred stock. Further, registered closed-end funds raise capital through the public offering process, either through an initial public offering and discrete follow-on offerings or through a continuous public offering. In a public offering, an investor pays cash in exchange for shares of the fund, rather than making a capital commitment subject to future drawdowns. As a result, a publicly offered fund may not be able to obtain a subscription facility and instead needs a financing collateralised by other assets, such as a NAV facility (as more fully described below).

Business development companies

BDCs are a close relative of registered investment companies. The BDC regulatory structure was designed to encourage additional lending and investment in U.S. middle market issuers. Accordingly, BDCs were granted some regulatory flexibility in exchange for a requirement to invest at least 70% of their investment portfolio in certain qualifying assets (generally private U.S. companies or listed companies with a market cap less than $250 million). BDCs are not registered investment companies, but instead elect to be subject to many of the substantive provisions of the 1940 Act and some distinct regulatory requirements. For example, subject to certain conditions, BDCs are permitted to maintain a 2:1 debt to equity leverage limit, which is notably higher than that for registered investment companies, and BDCs are permitted to have multiple classes of debt.

Similar to closed-end funds, BDCs may be publicly or privately offered. In addition, a BDC's shares may or may not be listed on an exchange. Unless a BDC is listed on an exchange, a publicly offered BDC will usually operate a periodic tender offer process similar to a non-traded closed-end fund. If a BDC is offered pursuant to a private placement, rather than through a public offering, it may operate a periodic repurchase programme or may instead choose to operate only for a limited term or in anticipation of a

future exchange listing. The terms of a private BDC's liquidity provisions are determined by the sponsor in the context of the BDC's investment strategy and the expectations of its investor base.

Publicly offered BDCs raise capital through a registration statement similar to registered investment companies. As with registered investment companies, investors in a publicly offered BDC pay cash in exchange for BDC shares. Privately offered BDCs, however, may operate a continuous private offering or may pursue a more conventional private placement drawdown structure. In the latter case, a BDC may therefore be able to benefit from a subscription facility.

Publicly registered, evergreen 3(c)(7) funds

A third category of the next generation of Regulated Funds is publicly registered, evergreen "private" funds. Similar to traditional private funds, these evergreen private funds are exempt from registration under Section 3(c)(7) of the 1940 Act because they are offered only to "qualified purchasers" (as defined above). However, since these funds are intended to attract more than 2,000 investors in a continuous offering, these funds register under the Exchange Act and engage in periodic reporting on Forms 10-K, 10-Q, and 8-K. Because these funds are exempt from registration under the 1940 Act, they are not subject to the leverage limits that are applicable to registered investment companies and BDCs.

In the current asset management market, publicly registered, evergreen 3(c)(7) funds are typically offered in a continuous private offering through intermediaries such as wirehouses, broker-dealers, and registered investment advisers. Publicly registered, evergreen 3(c)(7) funds usually operate monthly closings in which investors purchase fund interests for cash rather than through a drawdown structure. While these funds are not required to provide liquidity to their investors, sponsors may design such funds with a quarterly repurchase mechanism similar to a registered closed-end fund or BDC.

Operating company conglomerates

Another category involves a structure that is actually not a fund at all, but instead designed to fall outside of the definition of an "investment company" under the 1940 Act. This involves an issuer using a conglomerate structure that is commonly referred to as an "OpCo". OpCo conglomerates fall outside of the investment company definition under the 1940 Act by investing at least 60% of the OpCo assets in deals where the OpCo and its affiliates take a control stake in the target company. This investment emphasis on control stakes of underlying companies is a limiting factor for the deployment of the OpCo structure. However, because an OpCo falls outside the investment company definition under the 1940 Act, it is not subject to the 1940 Act's regulatory restrictions described in the introduction, including with respect to the use of leverage. In addition, because an OpCo is not an investment company and does not rely on the Section 3(c)(7) private fund exemption, it may offer its securities to accredited investors (rather than the more limited pool of qualified purchasers) in a continuous exempt offering under Regulation D or it may engage in a public offering pursuant to an effective registration statement. As with publicly registered, evergreen 3(c)(7) funds, OpCos usually operate monthly closings in which investors purchase interests of the OpCo for cash, rather than through a drawdown structure, and sponsors may design OpCos with a quarterly repurchase mechanism for up to 5% of the OpCo's value.

Tax treatment of Regulated Funds

The tax status of certain Regulated Funds is a primary focus of fund sponsors and their counsel, which impacts financing negotiations. The Internal Revenue Code (the "*IRC*") provides favourable tax treatment for regulated investment companies ("*RICs*") under Subchapter M. Registered open-end funds and closed-end funds and BDCs may all generally elect RIC status, though evergreen 3(c)(7) funds and OpCos are generally ineligible for RIC tax treatment and must rely on other provisions of the IRC. Unlike most corporations, a RIC can generally pass through distributed net income and long-term capital gains without incurring federal income taxes, as dividends paid by a RIC are generally deductible in computing

the fund's taxable income. Additionally, a RIC can generally pass through to shareholders the character of certain types of income and gains subject to tax at preferential rates (such as long-term capital gains and qualified dividend income).

To qualify as a RIC, a fund must derive at least 90% of its gross income from qualifying sources (such as dividends, interest, and gains from securities), and satisfy diversification requirements at the end of each fiscal quarter, among other requirements. Additionally, a fund must generally distribute at least 90% of its investment company taxable income with respect to each taxable year to qualify for RIC tax treatment. A RIC also must generally satisfy a minimum distribution requirement during each calendar year to avoid an excise tax on the amount of any under-distributions. For these reasons, when negotiating restricted payment covenants in the context of a financing for a RIC, borrower-side counsel will often advocate for increased flexibility to make tax distributions to satisfy the RIC distribution requirements noted above and avoid entity-level tax, including during times when distributions to investors are otherwise prohibited.

Financing options for Regulated Funds

Understanding the distinctions among Regulated Fund structures provides the foundation for evaluating the range of available financing solutions. The summaries below demonstrate how variations in fund structure, regulatory requirements and liquidity profiles influence how fund sponsors access leverage and manage capital needs.

Subscription facilities

Subscription facilities have been a favoured financing option for private funds for many years. A subscription facility is secured by: (i) the uncalled capital commitments of the fund's investors; (ii) the right of the fund and its general partner or similar managing entity to call capital from the fund's investors; and (iii) the accounts into which such capital contributions are deposited. The borrowing capacity under a subscription line (often referred to as the "borrowing base") is also determined by reference to the investors' uncalled capital commitments. As noted above, many Regulated Funds are structured such that they do not have any capital commitments; rather, investors fully fund their capital contributions upon their admission and do not have any future obligation to fund capital. Subscription facilities are simply not available as an option for such funds.

In the case of a privately offered BDC, or in the rare case that a subset of investors has agreed to make capital commitments to a Regulated Fund that does not otherwise have a drawdown mechanic, it is possible to utilise a subscription facility. However, in such case, any investors without capital commitments should be excluded from the collateral and the borrowing base. Similarly, the reporting and compliance obligations should not capture the investors that do not have capital commitments. In many ways, lenders may view this arrangement as a fund-of-one or a fund-of-a-few, since they can only rely on the anchor investors' capital commitments, notwithstanding the fact that the fund may have hundreds of other investors.

Net asset value facilities

Net asset value facilities ("*NAV Facilities*") are an attractive option for Regulated Funds because they rely upon the value of the fund's investments, as opposed to investors' capital commitments. The collateral provided under a NAV Facility ranges, but may include (i) the accounts into which investment proceeds and distributions are deposited, (ii) the rights to receive such investment proceeds and distributions, and/or (iii) a direct or indirect pledge of the fund's investments. There are special considerations applicable to Regulated Funds when negotiating a NAV Facility. For instance, any covenant that may prohibit the issuance of distributions will be problematic for a fund sponsor, given expectations to offer liquidity to investors. For these reasons, a fund sponsor should negotiate maximum flexibility to satisfy

such share repurchase, redemption or tender offer obligations, including in the case of a default or other compliance issue under the NAV Facility. Even if not strictly legally required, failure to provide liquidity to investors on the timeline that was previously disclosed will inevitably impair the commercial viability of the fund, which is not in the interest of any stakeholders. Similarly, as described above under "Tax treatment of Regulated Funds", there will be increased focus on the ability of a Regulated Fund to make tax distributions or other distributions necessary to maintain its regulatory status, as compared to a private fund. In each of these cases, to the extent the fund has liquid investments that are available to satisfy such obligations, and such investments are not pledged or subject to any restrictions under the NAV Facility, that will help alleviate some of the pressure with respect to such covenants.

The loan documentation for a NAV Facility may also limit amendments to the fund's governing documents or prospectus. It is difficult to anticipate all changes that a perpetual fund may need to implement with respect to its prospectus or governing documents, including in response to distribution requirements. Many potential amendments will be irrelevant to NAV Facility lenders, such as changes pertaining to subscription timelines, the establishment of new share classes, risk factors and other changes that do not impact the ability of the fund to incur indebtedness or repay obligations in respect thereof. A fund sponsor should therefore retain as much flexibility as possible to make any such required modifications quickly without having to obtain lender consent.

Credit fund NAV Facilities and collateralised loan obligations

NAV Facilities backed by portfolios of credit assets, such as private credit loans, will often follow a structured finance model, with bankruptcy-remote special purpose vehicles ("*SPVs*") acting as the borrowers and the distribution of proceeds received in respect of the assets being subject to strict limitations and payment priorities. Additionally, BDCs are increasingly turning to the capital markets for financing solutions by issuing collateralised loan obligations ("*CLOs*") backed by their portfolios of loans. Such structures necessarily afford less flexibility to fund sponsors, which can magnify the concerns around ensuring there are adequate available funds at the fund level to provide necessary liquidity to investors and to make tax distributions.

While such SPV borrowers and issuers typically are not themselves directly subject to the requirements of the 1940 Act, the leverage incurred by them will be taken into account when determining compliance by the related Regulated Fund with the leverage limitations and custody requirements imposed by the 1940 Act. As such, fund sponsors will need to ensure such facilities (1) are managed with an eye towards staying within the leverage limitations applicable to the Regulated Fund, as the failure to do so may result in a default under the NAV Facility or CLO, and (2) utilise a qualified custodian to hold the borrower's assets in compliance with the Regulated Fund's obligations under the 1940 Act.

Rated feeder funds and collateralised fund obligations

Recent years have seen a marked increase in the use of rated feeder funds ("*Rated Feeders*") and collateralised fund obligations ("*CFOs*") (together, "*Structured Funds*"), both of which are intended to attract a broader set of investors that look to gain exposure to investment funds through rated debt instruments. A Rated Feeder issues rated debt (often structured in tranches) and unrated equity to investors, and then uses the proceeds thereof to invest in a master fund. The rating on the debt is based on the credit quality and diversification of the underlying assets. Rated Feeders have become popular as feeder funds into Regulated Funds. A CFO is a structured transaction that issues various tranches of debt and equity, similar to a CLO, except a CFO is backed by a pool of interests in investment funds, instead of loans. While such products are primarily used for fundraising, as opposed to financing, their use of debt capital means sponsors confront many of the same challenges as would be present in a financing. These issues, such as ensuring adequate proceeds to satisfy principal obligations upon maturity and providing for adequate creditor remedies, can be complicated by the fact that a fund underlying these structures is a Regulated Fund.

Anti-Pyramiding Rules

A key hurdle for a Structured Fund that invests in a Regulated Fund is ensuring that it does not run afoul of the 1940 Act's anti-pyramiding rules (specifically Section 12(d)(1)) (the "*Anti-Pyramiding Rules*"). The Anti-Pyramiding Rules are designed to prevent excessive layering of fees and control issues by limiting the percentage of shares one investment company can acquire in another. As a result, the Anti-Pyramiding Rules restrict a Structured Fund from investing in a Regulated Fund if its investment would constitute more than 3% of the Regulated Fund's outstanding shares (unless the only investment security of the Structured Fund is its interest in the Regulated Fund). When coupled with the limitations discussed under "Regulated Fund liquidity" below, this can create structural issues if the Structured Fund would represent a significant portion of the Regulated Fund's shares (which is often the case, especially when the Structured Fund is used as part of the initial fundraising for the Regulated Fund). As a result, sponsors will need to ensure the Structured Fund is appropriately structured to comply with the Anti-Pyramiding Rules, while also satisfying any applicable rating agency requirements, in particular, the ability to generate sufficient proceeds to repay the debt at maturity. In addition, fund finance counsel should be involved in the structuring of the Structured Fund's investment into the Regulated Fund, as it may impact the borrowing base under a subscription facility.

Regulated Fund liquidity

In order to obtain ratings on the debt tranches issued by a Structured Fund, sponsors must ensure that the underlying funds in which a Structured Fund invests will produce sufficient cash flow to repay the debt prior to maturity. As discussed above, many Regulated Funds do not return capital outside of specified liquidity windows and may reinvest proceeds that otherwise would represent a return of capital. In such cases, only current income is likely to be distributed, and the Structured Fund may not receive a return of its invested capital in the normal course. As a result, the Structured Fund will need a mechanism through which its capital can be returned and used to amortise the debt. Exercising redemption rights or participating in a tender offer can expose the Structured Fund to market value risk *vis-à-vis* the fund's underlying assets. Further, Regulated Funds are generally restricted from creating redemption "sleeves", making distributions in kind or providing other preferential liquidity options that would otherwise be available to a private fund. Structured Funds that invest in Regulated Funds will therefore need to incorporate other structural features that will enable them to fully amortise the debt within the stated maturity.

Financing negotiation considerations

A review of the various financing solutions available to Regulated Funds reveals several common themes that apply across different fund structures:

- The ability of any Regulated Fund to incur debt may be subject to regulation. Funds counsel should confirm compliance with any debt limitations set forth in the fund's governing documents and any applicable regulation. This guidance applies even if the debt is incurred at an SPV below the fund or the registrant.
- There is increased emphasis on liquidity options available to both the fund and, ultimately, its investors. Restricted payment covenants should provide sufficient flexibility to ensure that the fund is able to honour investor redemption and share repurchase requests. This is especially important if the fund does not have access to cash outside of the assets pledged in connection with the financing.
- The fund's tax status is paramount. Fund sponsors should negotiate maximum allowance to make any required tax distributions, including exceptions to any restricted payment covenants.
- Funds counsel should review any limitations on amendments to governing documents or the fund prospectus and negotiate appropriate carve-outs.

- The interplay between Structured Funds and Regulated Funds requires special attention and coordination among relevant counsel to ensure applicable rating agency criteria are satisfied while complying with all applicable regulations.

In addition, given that certain Regulated Funds are subject to public reporting requirements, fund sponsors should discuss with funds counsel any disclosure considerations with respect to the proposed financing. Borrowers should review the loan documentation to ensure that they are able to file key loan documents to the extent required and/or otherwise disclose facility terms and documents to the SEC. Borrowers may also minimise their ongoing compliance obligations by providing that any filing with the SEC is deemed to constitute delivery to the agent or the lenders under the loan documents. In any case, the substance and cadence of any reporting obligations under the facility should mirror that which the fund is preparing for its investors and the SEC.

It is important to note that the above list is not intended to be exhaustive, but rather highlights key issues unique to Regulated Funds seeking financing arrangements.

Conclusion

It is an exciting chapter in the story of fund finance, as the types of products that fit under the fund finance umbrella continue to expand. New types of Regulated Funds present a challenge to fund finance advisers, who are tasked with crafting financing solutions that will support a fund's capital needs throughout its life cycle, while ensuring alignment with investor expectations and compliance with the regulatory guardrails imposed by the SEC. Given the prevalence of novel fundraising strategies in an increasingly complex regulatory landscape, it is crucial that fund sponsors engage experienced legal counsel who understand the nuances of such structures and their potential impact on the fund's use of leverage.

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Ashley Belton Gold

Tel: +1 212 455 3499 / Email: ashley.beltongold@stblaw.com

Ashley Belton Gold is a Partner in Simpson Thacher's Banking and Credit and Fund Finance Practices. Ashley's practice is focused on crafting tailored financing solutions for investment funds with complex structures across a variety of asset classes, including private equity, real estate, credit, secondaries and infrastructure. She regularly advises financial sponsors on a wide range of fund-level financings, such as subscription facilities, NAV-based facilities and unsecured demand lines, among other bespoke arrangements. Ashley has extensive experience structuring co-investment loan programmes, which provide opportunities for employees and other professionals to participate in investments, in addition to lines of credit for general partners and investment advisers, which provide liquidity for working capital and funding of capital commitment obligations. Ashley's practice provides clients with flexible liquidity solutions that are increasingly essential for investment funds to competitively manage their businesses from fundraising through dissolution.

Adam Z. Risell

Tel: +1 202 636 5971 / Email: adam.risell@stblaw.com

Adam Z. Risell is a Partner in Simpson Thacher's Investment Funds Practice and is based in the Washington, D.C. office. He advises asset managers and sponsors in connection with a broad range of capital raising activities utilising structured finance technology, including the formation of complex investment vehicles, such as rated note fund structures, collateralised fund obligations, and securitisations and other capital-efficient investment products, including those designed for investment by insurance companies. He also advises on the development and distribution of collateralised loan obligation captive funds, risk retention vehicles and other similarly specialised funds. Adam also counsels business development companies and other registered funds relating to structured financing techniques.

Adam S. Lovell

Tel: +1 202 636 5500 / Email: adam.lovell@stblaw.com

Adam S. Lovell is Counsel in Simpson Thacher's Registered Funds Practice. He focuses his practice on a broad range of investment management issues related to registered funds, registered investment advisers and fund boards. He advises asset management firms on compliance with the Investment Company Act and the Investment Advisers Act, and on the operation of investment funds across various types of registered fund structures, including interval funds, listed closed-end funds and business development companies.

Adam has extensive knowledge of the regulatory requirements of the asset management industry, having previously served as Senior Counsel at the Securities and Exchange Commission in the Rulemaking and Chief Counsel's Offices of the Division of Investment Management. He has also spent time in private practice, having worked in the asset management group at another international law firm.

Simpson Thacher & Bartlett LLP

425 Lexington Avenue, New York, NY 10017, USA

Tel: +1 212 455 2000 / URL: www.stblaw.com

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