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Private Fund Side Letters—Investor Agendas, Tactics and Disclosure

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Side letters are separate agreements that supplement or modify the terms of the governing documents of a private fund. For large, seed, and strategic investors, side letters have become an important part of any private fund investment regardless of whether the fund is a hedge fund, private equity fund, or venture capital fund. Over time and particularly following the Madoff scandal, the side letter terms investors request have become increasingly complex, costly and administratively burdensome. In this article, the authors examine the side letter agenda for different types of investors, negotiation tips and tactics, administrative considerations and disclosure best practices.

The Investor Agenda

Side letters are generally limited to only the largest investors in a fund. In return for committing a substantial amount of capital or being an early investor, an investor can negotiate preferential terms, which may range from discounted fees to additional investment capacity.

Investors' desired side letter terms vary greatly by investor type. For example, a fund of funds generally has vastly different concerns than a sovereign wealth fund. To better understand certain investors' motivations, below is a summary of terms different investors typically seek from managers. The summary below is by no means exhaustive.

Fund of Funds

Funds of funds are an important allocator of capital to private funds. Funds of funds offer their investors the advantage of liquidity (hedge funds), diversification and access to underlying managers which may not otherwise

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be available to the investor.

Hedge funds of funds are generally focused on most favored nations (MFNs, discussed in more detail below); key person provisions (that is, redemption or wind-down right if employee(s) dies, becomes incapacitated or is unavailable to manage the fund); liquidity; reporting; transparency; and capacity.

Following the Madoff scandal, hedge funds of funds are under enormous pressure to have full portfolio transparency at the underlying fund level. As a result, data aggregators, which can aggregate multiple managers' trading data, have become very important for marketing and portfolio management purposes. Funds of funds will often seek special reporting rights from a manager so that portfolio information is provided to the data aggregator. Funds of funds also will seek to disclose, generally on a no-names basis, portfolio and other manager information to their investors. As funds of funds may have investors subject to public reporting requirements like the Freedom of Information Act (FOIA), negotiations with the underlying managers, who wish to protect their information, can be contentious. Hedge funds of funds managers also often seek the ability to transfer investments between affiliated funds without incurring any redemption fees or the resetting of lock-up periods or high water marks.

Private equity funds of funds concentrate on MFNs, confidentiality, reporting, advisory board seats, and co-investment rights. Similar to hedge funds of funds, private equity funds of funds want to ensure they can communicate manager information to their investors as well as provide certain limited information to prospective investors. As a result, private equity funds of funds often seek amendments to a fund's confidentiality provisions. In addition, private equity funds of funds often seek to obtain more expansive information rights in order to fulfill their tax reporting obligations as well as to ensure ASC 820 (formerly FAS 157) compliance. Information rights provisions run the gamut from very detailed requirements to broader assurances that a manager will provide such additional information as reasonably requested to facilitate tax reporting.

Private equity funds of funds may also seek advisory board rights, which are an important tool for monitoring a manager's activities and are something investors in funds of funds like to see. Private equity funds of funds often request co-investment rights or at least an acknowledgment from the manager that a fund of funds is interested in receiving co-investment opportunities. Finally, a private equity fund of funds may seek side letter provisions to ensure that the terms of an investment do not conflict with the fund of funds' governing documents. For example, a fund of funds whose governing documents limit the percentage of permissible non-US investments might request that a manager confirm that it does not intend to make non-US investments in excess of a certain percentage.

Sovereign Wealth Funds

Since the 1990s, the growth of assets held by foreign governments has skyrocketed and sovereign wealth funds (SWFs) have increasingly sought to invest in private funds. As large investors, SWFs focus on management and performance fees, MFNs, disclosure of confidential information, sovereign immunity, and other terms which conflict with their sovereign status, such as US tax matters.

MFNs generally entitle the SWF to be informed of preferential terms entered into with other investors along with the option to elect such terms. SWFs also will often seek amendments to a fund's confidentiality provisions in order to comply with applicable disclosure laws similar to FOIA.

Sovereign immunity negotiations are often tricky, since limiting the fund's ability to sue and recover damages from the SWF may result in adverse consequences for other investors in the fund. While the SWF may want to reserve all immunities to which it is entitled as a sovereign, funds should avoid conceding that SWFs are immune from suit.[1]

SWFs often argue they have no ability to provide an indemnity. The typical compromise is a provision whereby the SWF's indemnification obligation will not exceed its investment or capital contribution. Another battle with SWFs is the governing jurisdiction of the fund documentation. The SWF will seek to have its laws govern the subscription agreement and side letter.

State Governments

With substantial defined benefit assets, state governments are large allocators to private funds. State government concerns often mirror those of SWFs.

State governments are typically concerned with fees, MFNs, disclosure of confidential information, and sovereign immunity, as the Eleventh Amendment to the US Constitution affords them protections from suit. State governments will generally seek an acknowledgment of their sovereign status and seek to limit the venue for lawsuits against them to their home state.

State governments often claim they are barred by their constitution to provide an indemnity, but often will agree to limit the indemnity to the value of the investment or the initial capital contribution. The state also may request that the manager comply with its investment policies, which may be derived from various laws applicable to the state. While a compromise can often be reached, agreeing to abide by a state's investment policy can be a compliance headache.

Pension Plans

Pension plans, which are frequent investors in private funds, often have lengthy, form side letters that include, as expected, provisions on the Employee Retirement Income Security Act of 1974 (ERISA). Plans' primary focus is usually on ensuring their assets are managed in accordance with ERISA.

Many pension plans seek provisions requiring the manager to treat a fund as if it were a "plan assets vehicle"[2] even if the fund is not. This includes getting representations from the manager that it acknowledges it is an ERISA fiduciary, an "investment manager" under Section 3(38) of ERISA, and a Qualified Professional Asset Manager (QPAM).[3] Other provisions include requirements for the fund to provide information necessary so that the pension plan can complete its Form 5500 (an annual government filing for employee benefit plans). Pension plans also may seek to have the manager maintain a fidelity bond for ERISA investors.[4] Pension plans often seek to restrict the fund's ability to distribute assets in kind, and may attempt to require the fund to establish a liquidating entity to dispose of any in-kind distributions.

Large Private Wealth Managers

In general, private wealth managers are primarily concerned with fees. In addition, private wealth managers often seek notice if the fund would be considered a "plan assets vehicle" under ERISA. Given the number of services provided by affiliates of private wealth managers to their investors and/or the fund, private wealth managers want to avoid the potential for prohibited transactions. As a result, private wealth managers may seek the right for their ERISA investors to redeem if the fund becomes a plan assets vehicle. Similar to funds of funds, private wealth managers also will seek exceptions to a fund's confidentiality provision so that they can share information with clients and prospective clients. Requests for notice of regulatory investigations of the manager or the fund, while not unique to large private wealth managers, are also often requested.

Negotiation Tips and Tactics

Side letters have evolved greatly as the words "hedge fund" and "private equity" have gone mainstream. The number of provisions investors seek, and such provisions' complexity, has increased substantially. The summary above illustrates this point. As a result, both managers and investors need to develop their own side letter "playbook." Investors and managers will want to agree on the standard terms they are willing to offer and/or accept and have a process for handling deviations.

Investors

Included in the playbook for many large private fund investors is a template side letter developed with the assistance of counsel. While an investor might not provide its entire template to a manager, it often will provide selected terms which are of great importance to the investor. For example, state governments often provide the manager language requiring compliance with applicable investment guidelines

such as a ban on investing in Sudan;[5] a pension plan will provide its preferred ERISA terms; and a hedge fund of funds manager will include a provision entitling it to transfer investments between affiliates without incurring redemption fees or the resetting of lock-ups or high water marks.

A strategy many investors employ is to request all outstanding side letters when conducting due diligence. If provided, investors can pick and choose provisions they want to include when negotiating their side letter. An alternative to requesting all side letters is to request a summary of existing side letter terms.

Confirming the interpretation of side letter terms with the manager is important. Being specific when drafting is extremely important. A common manager tactic is to narrow the scope of a side letter provision. For example, when negotiating an MFN, the manager may propose various carve outs where the MFN would not apply, including limiting the MFN to the proposed investment vehicle. Investors will want to review each side letter provision in detail and understand its limitations.

Large investors often employ experienced counsel either in-house or externally to negotiate side letter provisions. Counsel can provide invaluable guidance in interpreting manager proposed side letter terms.

While side letters are beneficial, investors need to understand their limitations. The global economic crisis of 2008–2009 illustrated that side letters are not always worth the paper they are printed on when funds are under substantial redemption stress. For example, a hedge fund manager may make the difficult decision not to honor side letter terms which modify liquidity provisions such as gates (mechanisms used to limit the percentage of capital that can be redeemed at one time–for example, 25 percent per quarter) or lock-up periods (the amount of time capital must be invested before it can be redeemed) because of fiduciary concerns even though permitted by the hedge fund's governing documents. In such a situation, investors may be left weighing whether to commence suit against the manager to honor the side letter term.

Managers

Managers will want to develop their own template side letter and inform investors early in the process to use the template to avoid unnecessary negotiations. Managers should consider forming a committee, which would include members of the firm's key business units, to vet side letter terms. Side letter provisions can have a broad impact and affect different business units throughout the firm, including information technology, compliance, accounting, investor relations, and investment management. For example, fee breaks will usually involve accountants, legal, and compliance analyzing whether any MFNs have been tripped, and potential lost revenue. Without careful consideration, a new mandate could end up actually decreasing total firm revenues. The coordination of various business units to assess potential side letter terms is very important to avoid making compliance too complex. Below are a few practices managers utilize when negotiating side letters.

Keep Terms Consistent Across Side Letters. Minor differences among similar terms can make compliance difficult. For example, granting different key person provisions could result in a clause being triggered for certain investors and not others. It is best to have only one key person clause.

MFNs. MFNs are often the most complex section of any side letter. Managers often tie their MFNs to the investor's capital commitment. In other words, only preferential terms granted to smaller investors would trigger the MFN. Managers also should draft their MFNs to require that the investor take the "benefit" and the "burden" of any preferential term granted to another investor. For example, if a fee discount is granted to another investor in exchange for a longer lock-up period, the investor electing the MFN term should be required to agree to the longer lock-up period in order to receive the fee discount. Careful drafting is required to avoid investors being able to avoid the "burden" of an MFN.

MFN Carve Outs. It is important to include carve outs to the MFN. For example, a manager may want to exclude, among other things, other funds, separate accounts, legacy investors, employees and affiliates of the manager,

and terms granted to address legal or regulatory issues. Many managers will refuse to permit MFNs to apply across multiple funds. An attractive strategy is to offer a fee-only MFN, meaning investors cannot negotiate other terms.

Create an MFN Election Summary. As each MFN likely requires the delivery of side letter terms to investors who are eligible to receive them, using a form whereby the investor can simply check if it wants the term avoids potential negotiation. For private equity funds, it is best to distribute the election summary after the final close to avoid investors being able to elect various iterations of the same term.

Avoid Preferential Liquidity. Many hedge fund managers seek to avoid providing preferential liquidity to investors through side letters. While many managers offer different liquidity options such as varying lock-up periods and redemption periods in the offering memorandum, providing liquidity through a side letter creates fiduciary concerns.

Avoid Investment Restrictions. To the extent possible, avoid investor driven investment restrictions for commingled private funds. Agreeing to investment restrictions may result in the substantial alteration of a fund's investment strategy necessitating disclosure to other investors. Steer the investor toward a separate account or other customized products to the extent the investor requires custom investment restrictions.

Administrative Considerations

Given that most large investors will request a side letter, the administrative burden imposed by agreeing to multiple side letters can be onerous and can substantially increase costs for a manager. Simply keeping track of all of the provisions can be a major headache. MFNs impose some of the most difficult monitoring tasks, since decisions need to be made as to whether a preferential term needs to be offered to an investor. Limiting the number of MFNs or providing them to all investors are different strategies managers employ.

Managers often underestimate the time and effort necessary to monitor compliance with side letter terms. Following the Madoff scandal, the portfolio and related fund information that must be reported by managers has increased substantially. Many of the new reports are included in side letter terms. As a result, many firms have hired additional compliance and investor relations staff to respond to the increase in customized reporting requests.

Here are several strategies managers can use to combat the side letter onslaught.

Stick To Your Guns. Set boundaries for certain provisions, and stick to them. For example, give only one key person provision, have it apply to all investors, and do not accept deviations.

Develop a Side Letter Summary and Checklist. Use summaries and checklists to assist with the monitoring of side letter compliance. Many hedge funds run monthly compliance checks on side letter terms.

Use your resources. Managers should contact their administrators to see if they can assist with the monitoring of side letter terms.

Approval process. Develop an efficient approval process that is capable of quickly vetting potential side letter terms and their impact on business units. As noted above, forming a side letter committee may be beneficial. Include in the approval process the offshore board, as necessary or required.

Think big. Managers can be shortsighted when granting side letter terms. For example, creating a tiered management fee schedule based on the amount of assets committed to a fund or the firm is easier and optically better for investors than agreeing to numerous one-off fee deals.

Reporting. As much as possible, get investors to agree to a standardized reporting package and avoid customized reporting.

Disclosure Best Practices

Regulatory Considerations

Although side letters are very common among private funds, just a few years ago their use was under intense scrutiny by regulators. In 2006, the United Kingdom's Financial Service Authority (FSA), in its Feedback Statement FS06/2, noted its disapproval of side letters. The FSA stated that it expected managers to disclose to investors when a side letter

was granted and any conflicts that may arise and how they are adequately managed. In response to the Feedback Statement, which had UK managers concerned, and following discussions with the FSA, the Alternative Investment Management Association (AIMA) issued a Guidance Note providing that hedge fund managers were expected to disclose the existence and nature of side letters entered into with investors if those side letters contain material terms.[6] Among the items deemed material by AIMA were preferential liquidity, key person provisions and portfolio transparency. Non-material terms include MFNs and fee discounts.

In the US, the SEC Staff has never issued formal guidance on the use of side letters. As a result, opinions vary widely on the SEC's scrutiny of side letters, from an outright ban, to a negative inference, to no concerns. Our experience is that the SEC is focused on ensuring that conflicts of interest are adequately disclosed or mitigated, but that the use of side letters does not in and of itself create a negative inference during an SEC examination. In a May 2011 speech, Carlo V. di Florio, the Director of the SEC's Office of Compliance Inspections and Examinations, acknowledged that the SEC will look at conflicts of interest between the manager and its private equity funds, including side letters that give certain investors preferential terms.[7] To our knowledge, the SEC has never called for a side letter ban.

In 2006, during a speech to the US Senate, the SEC's then Director of the Division of Investment Management noted the SEC's concerns with regard to side letters.[8] She noted that preferential liquidity and preferential access to portfolio information caused the most concern, whereas investment capacity, MFN clauses, and fee reductions posed less concern.

A recent SEC investigation illustrates that preferential liquidity continues to be a concern for the SEC. In December 2011, Harbinger Capital Partners, a hedge fund manager, received a notice from the SEC that it was prepared to bring suit against Harbinger for, among other charges, permitting Goldman Sachs to withdraw $50 million from its funds pursuant to a side letter at a time when other investors were restricted from redeeming capital.[9] The issue is whether Harbinger properly disclosed the side letter to investors.

When drafting side letter disclosures to investors, managers should also keep in mind the fiduciary duty embedded in the Investment Advisers Act of 1940 (Section 206) (Advisers Act) and the anti-fraud provisions under the Securities Act of 1933 (Section 17) and the Securities Exchange Act of 1934 (Rule 10b-5). Rule 206(4)-8 of the Advisers Act, which applies even to unregistered investment advisers, prohibits an adviser from making false or misleading statements of material fact to current or prospective investors or engaging in other fraudulent conduct with respect to a fund's investors.

Where Does Side Letter Disclosure Appear?

Before discussing what managers disclose, it is helpful to understand where side letter disclosures appear. While the offering memorandum for a fund is an obvious place, managers may provide investors with other documents that may include disclosure of preferential terms. This includes the firm brochure under Form ADV for SEC registered investment advisers, responses to requests for proposals (RFPs) or information (RFIs), and ongoing reporting to investors. Because disclosure of preferential terms can appear in places other than the offering memorandum, managers should consider keeping an inventory of disclosures so that updates can be carried through all firm disclosures. Two of the most overlooked disclosure areas is RFPs and RFIs. Firms often use canned language that may become stale.

Disclosure Best Practices

According to the 2009 Asset Managers' Committee of the President's Working Group on Financial Markets: Best Practices for the Hedge Fund Industry (Working Group), "… where side letters provide investors with terms that may adversely impact other investors in the fund, the [m]anager should make such disclosure as reasonably necessary to enable other investors to assess the possible impact of such side letters on their investment."[10] In

other words, managers should ensure that they disclose to investors side letter terms involving potential material conflicts of interest. This principle, which follows the SEC and FSA regulatory approaches, applies equally to private equity and other private funds. In discussing what types of terms should be disclosed, the Working Group noted the following: enhanced control rights; preferential liquidity/redemption rights; preferential fees; and terms that materially alter the investment program described in the offering materials.

Here are several suggestions to consider when drafting side letter disclosure.

Conflicts inventory. Take an inventory of your side letter terms and determine whether there are any material conflicts to disclose.

Be specific. Generic disclosure that the fund may provide preferential terms to investors may be helpful in litigation, but specific disclosure as to the types of preferential terms granted to investors is better. In particular, disclose whether the fund will grant preferential liquidity or fees or portfolio transparency. For private equity funds, detail whether co-investment rights may be granted to investors. A number of the required items (5, 6, 8, 10 and 11) in the firm's brochure (Part 2 of Form ADV), if registered, will cover conflicts created by side letter terms.

Be consistent. Make sure disclosure of side letter terms in the fund offering materials matches the disclosure in the manager's firm brochure (Part 2 of Form ADV), if registered, and in other documents maintained by the manager.

Obtain Sample Disclosure. Review other managers' firm brochures at *http://www.sec.gov/divisions/investment/iard.shtml* for examples of side letter disclosure. Ask outside counsel for examples of sample disclosures.

Conclusion

Side letter practices vary widely among managers and investors alike, and this article only scratches the surface of these practices. For managers, understanding an investor's agenda before starting a negotiation is helpful to devise ways to satisfy the investor's concerns. Managers also need to create a playbook to help manage the side letter process and avoid provisions that are administratively burdensome and costly. Thinking big will help firms avoid onerous side letter provisions. For investors, consider developing a template side letter and use it to start the negotiation process.

Notes

1. *See* Foreign Sovereign Immunities Act of 1976 for more information on the limitations as to whether a foreign sovereign nation may be sued in US courts, and the exceptions to immunity such as where the sovereign acts in a commercial capacity in the US. *See also* Republic of Argentina v. Weltover, 503 U.S. 607 (1992).

2. As a general rule, if benefit plan investors own more than 25% of any class of equity interest in a hedge fund or private equity fund, the fund will be a plan assets entity under ERISA. If the fund is a plan assets vehicle, the manager will be a fiduciary to each ERISA investor in the fund and subject to, among other things, the prohibited transaction rules. *See* Definition of "Plan Assets," Section 3(42) and Department of Labor (DOL) Regulation 2510.3-101. A fund also may seek to qualify as a "Real Estate Operating Company" or a "Venture Capital Operating Company" to avoid being deemed a plan assets vehicle.

3. *See* PTCE 84-14, as amended, which details the requirements for being a QPAM. A QPAM includes an investment adviser registered with the Securities and Exchange Commission with $85 million in assets under management and shareholders'/partners' equity of at least $1 million as of the last day of its most recent fiscal year. Being a QPAM exempts the manager from certain types of prohibited transactions.

4. ERISA generally requires that every person who handles plan assets must be covered by a fidelity bond. *See* Section 412 of ERISA and DOL Regulations 2550.412-1 and 2580.

5. Various states have Sudan divestment statutes. *See, e.g.*, Protecting Pennsylvania's Investments Act, S.B. 928.

6. AIMA Guidance Note (Sept. 28, 2006), available at *http://www.aima.org/uploads/IndustryGuidanceNoteSideLettersPublic.pdf.*

7. Speech by Carlo V. di Florio at the Private Equity International's Private Fund Compliance (May 3, 2011), available at *http://www.sec.gov/news/speech/2011/spch-050311cvd.htm*.

8. Susan Ferris Wyderko, Testimony Before the Subcommittee on Securities and Investment of the United States Senate Committee on Banking, Housing, and Urban Affairs (May 16, 2006).

9. "SEC Puts Falcone, Harbinger in Its Sights," *Wall St. J.* (Dec. 10, 2011).

10. Asset Managers' Committee of the President's Working Group on Financial Markets: Best Practices for the Hedge Fund Industry (Jan. 15, 2009), available at *http://www.amaicmte.org/Asset.aspx*.

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