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KEY CONSIDERATIONS AND TACTICS IN NEGOTIATING SIDE LETTERS FOR PRIVATE FUNDS

Prospective investors frequently negotiate for side letters to vary the terms of their investment in a private fund from the terms set forth in the fund's governing documents. The authors discuss the subjects frequently raised in such negotiations, the differences between PE Funds (closed-end) and Hedge Funds (open-end), the authority to enter into side letters, and MFN provisions. They then cover a number of issues pertaining specifically to PE funds and to Hedge Funds. They close with a note on compliance.

By Kelli L. Moll and Omoz Osayimwese *

Side letters are commonly requested, and in many instances required, by investors in private funds, whether such funds are in the form of closed-end funds (collectively referred to as "PE Funds") or open-end funds (collectively referred to as "Hedge Funds"). Investors use side letters to vary the terms of a specific investor's investment in a private fund from the terms set forth in the governing documents for such a fund. An investor may want to enter into a side letter to address legal, tax, or regulatory issues that are specific to that investor, but not necessarily applicable to other investors in the fund. Side letters can also be used to deal with investment restrictions or guidelines applicable to a specific investor, including "sanctioned" investments, environmental, social and governance considerations ("ESG"), and socially responsible investing (e.g., prohibitions of alcohol, tobacco, and similar types of investments). Finally, side letters are used to negotiate discounts to management fee and carry/incentive allocation rates, liquidity rights, transparency rights, and other reporting rights.

Side-letter negotiation has become a common practice in the capital raising process for private fund managers, resulting in the fundraising process becoming more complex and the tracking of these additional rights burdensome for both sponsors of PE Funds and Hedge Funds. While side-letter negotiation has been a historic fixture for PE Funds, in Hedge Funds this has become more prevalent and the tactics to avoid such negotiations harder, as there is more institutional capital in the market and less high net-worth investor capital. In particular, for sponsors of Hedge Funds, these issues can continue indefinitely, as Hedge Funds often engage in a continuous offering process, as opposed to PE Funds, which have a limited period in which to fundraise. Another evolution in this practice relates to the fact that many institutional investors have retained outside counsel in connection with their fund investments, creating a cottage industry of side-letter negotiation and process for fund reviews. As both institutional investors and private fund sponsors try to harmonize how they handle their investments, on the one hand, and their investors, on the other hand, both parties are seeking to establish precedents and procedures to ensure the rights obtained and compliance obligations owed become uniform across their respective platforms.

* *KELLI L. MOLL is a partner at Akin Gump Strauss Hauer & Feld LLP. OMOZ OSAYIMWESE is a partner at Dechert LLP. Their e-mail addresses are kmoll@akingump.com and omoz.osayimwese@dechert.com.*

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PE FUND SIDE LETTERS VS. HEDGE FUND SIDE LETTERS

While the side-letter negotiation process is similar for both managers of PE Funds and Hedge Funds there are key differences each manager considers. The issues all managers have in common include dealing with requests such as: (i) Most Favored Nations ("MFN") provisions; (ii) management fee and carried interest/incentive allocation rate discounts; (iii) provisions related specifically to seed or anchor investors; (iv) tax covenants on such issues as unrelated taxable income (UBIT); effectively connected income (ECI); audit rights, prohibited listed transactions and tax reporting; (v) sovereign immunity provisions; and (vi) waivers to certain of a fund's confidentiality provisions, both as they relate to information investors must keep confidential, as well as how the managers must treat investor information, including addressing freedom of information act requests ("FOIA").

Differences in side-letter negotiation between PE Funds and Hedge Funds are often based upon the fact that Hedge Funds provide periodic liquidity to their investors, allowing them to redeem, where there is no corresponding liquidity rights given to investors in PE Funds. In addition, Hedge Funds engage in a continuous offering and this makes the side-letter process with MFN provisions live on indefinitely. Conversely, because of the long life of a typical PE Fund, where investors are locked-up, there is often an expectation of extensive negotiation of side letters and fund documentation that is less often seen in Hedge Funds.

For managers of Hedge Funds, the most significant issues raised in side-letter negotiations relate to requests around liquidity and transparency. These requests raise fiduciary duty issues for Hedge Fund managers, who have an obligation to treat investors fairly and to avoid situations where certain investors may have better liquidity rights or transparency rights that would permit them to "front run" other investors in redeeming from the fund.

While most Hedge Fund investors no longer ask for better redemption terms in the form of additional redemption opportunities or shorter notice periods, there are a number of requests that managers of Hedge Funds typically address with their investors around issues of liquidity. These requests include provisions prohibiting an in-kind distribution of securities in connection with a redemption, a prohibition on the side pocketing of illiquid securities, the elimination of audit holdback or reserves, the discounting or elimination of the management fee while a Hedge Fund suspends liquidity, allowing redemptions with replacement capital at a time that is "off-schedule" from the regular redemption rights, the aggregating of investor-level gates among affiliated investors, and regulatory issues allowing investors to receive special liquidity rights (e.g., ERISA and Bank Holding Company Act).

Transparency issues, however, are often a more difficult area for Hedge Fund managers to negotiate, as such information can influence the exercise of a redemption right. In reviewing these requests, managers must consider whether it would provide such information to all investors, as opposed to a specific investor through a side letter. Transparency rights include, but are not limited to, notice of key events related to the principals and the manager, notice of regulatory investigations and proceedings, notice of litigation both pending and threatened, disclosure of portfolio holdings, specialized performance reporting, and notice of representation and warranties no longer being true, when given either in a side letter or other fund document. These types of transparency rights may be given more freely by a PE Fund manager because of the absence of redemption rights by investors in a PE Fund, where liquidity is in the form of distributions made as investments are sold.

AUTHORITY TO ENTER INTO SIDE LETTERS

In a typical limited partnership agreement for a Delaware private investment fund, it is common (and best practice) for such agreement to have a provision that expressly permits the general partner of the fund to enter into side letters with investors that vary the terms of that investor's investment in the fund from those set forth in the limited partnership agreement. For offshore Hedge Funds established using a corporate structure (e.g., offshore funds set up as Cayman Islands-exempted companies), typically the terms of the fund are set forth

in the offering document for such fund (and not in such fund's articles and memorandum of association). Having the authority to enter into side letters be expressly set forth in a fund's governing documents is important, particularly since in some cases, institutional investors may require separate legal opinions on the enforceability of an investor's side letter. Furthermore, while side letters can be used to override terms in partnership agreements, limited liability company agreements, offering memoranda, and subscription agreements, to the extent permitted by the amendment provisions, side letters can never override the provisions of an offshore fund's memorandum and articles of association. Finally, as a technical drafting point, side-letter covenants should be carefully drafted to ensure that the correct party is making the covenant. Forms of side letters often have all fund parties (i.e., the manager, general partner, onshore fund, offshore fund, and master fund) making all the agreements in the side letter, where it is more appropriate for a smaller subset of parties to be making the covenants contained in the letter, based on the knowledge and authority of the relevant party.

MOST FAVORED NATIONS PROVISIONS

The MFN provision is a common side-letter ask from investors in PE Funds and Hedge Funds. MFN provisions provide investors with the right to elect to receive the benefit of more favorable terms that have granted to other investors pursuant to such other investors' side letters.

MFN provisions in PE Funds, subject to certain exceptions, typically apply to the full range of terms that might be included in a side letter. In Hedge Funds, an MFN may cover the same scope as described above for PE Funds, or may be limited to cover only "fees and liquidity" or "fees, liquidity, and transparency," depending on the bargaining strength of the Hedge Fund manager. The actual language of the MFN provision will usually provide that, subject to such exceptions, either (i) an investor will get the right to elect to receive the benefit of all of the more favorable rights granted to all other investors pursuant to such other investors' side letters or (ii) such investor will get the right to elect all of the more favorable terms granted in the side letters for all other investors that have made capital commitments to the fund equal to or smaller than that made by such investor (the right described in (ii) is known as a "size-dependent" MFN provision). Hedge Funds typically make the election of MFN rights size-dependent, but in lieu of relative capital commitments, Hedge Funds will either measure capital contributions made to the fund or use a formula of net subscriptions (capital contributions less redemptions). Net subscription formulations may be difficult to track, and there can be negotiation around whether redemptions should be viewed as redeeming profits first before capital contributions or ratably of both profits and capital contributions.

Typical exceptions to the MFN provision include side-letter provisions given to investors in order to address tax, legal, regulatory, or accounting issues applicable to investors that are not applicable to the investor holding the MFN right, provisions regarding membership or observer rights on the LP advisory committee, and rights granted to investors that are affiliates of the general partner (e.g., waiver of management fees and carried interest). Some MFN provisions extend the list of exceptions to include other terms, such as co-investment rights, transfer rights, reporting provisions, confidentiality/use of name provisions, rights granted to seed investors, etc. In addition, in drafting side-letter provisions it may, on occasion, be advantageous to draft a requested provision in a manner that ties the substance of the provision to the specific factual, commercial, tax, legal, regulatory, or accounting circumstance that caused the investor to request (and/or the general partner to agree to) such provision. For example, a provision requiring the general partner to provide certain information on the fund to the investor (not otherwise provided to other investors) because the investor is subject to (or has elected to be subject to) certain tax, legal, or regulatory regimes, or because the investor is subject the laws of a non-U.S. jurisdiction, may be drafted in a way that reflects how specifically the investor's circumstances and/or tax, legal, or regulatory status are the reason that the general partner is providing the investor with the requested information. Drafting a side-letter provision in this manner helps to ensure that only those other investors with the same circumstances as the investor for whom the provision was originally drafted would be able to elect to receive the benefit of such provision under the MFN process.

It is not uncommon for entities that are affiliates of each other to invest in the same fund. As a result, in determining whether an investor is larger or smaller than another investor (and thus whether the investor with the MFN right can elect to receive more favorable terms granted to the smaller investor), many MFN provisions aggregate an investor's capital commitment/capital contributions/net subscriptions to the fund with the capital commitments/capital contributions/net subscriptions to the same fund of the investor's affiliates. Many consultants or other gatekeepers may have multiple clients who invest in the fund that are not necessarily affiliates of the consultant since those clients may make independent decisions as to whether to invest

in the fund (even if recommended by the consultant). Such consultants may also manage accounts or investment vehicles over which they have investment discretion. In many cases, those consultants will want all of the accounts and investment vehicles that they control, as well their unaffiliated clients (where they do not have investment discretion), that invest in the same fund, to be aggregated for purposes of determining MFN rights. To the extent that a general partner agrees to aggregate all clients of a consultant, the general partner may want to limit the aggregation to clients that are affiliates of the consultant prior to the time that the first client of the consultant invests in the fund.

OTHER ISSUES PERTAINING SPECIFICALLY TO PE FUNDS

General

Negotiating side letters is a major part of the fundraising process for fund sponsors once they (i) are done preparing and distributing offering documents; (ii) have spent time gauging interest from prospective investors; and (iii) are ready to have an initial or subsequent closing for the fund. Side letters have also in recent years become lengthier and more extensive. In particular, when investors who participated in a predecessor fund try to include in their side-letter requests for a successor fund both the provisions that they negotiated for in their original side letters for the predecessor funds as well as the provisions they elected pursuant to the MFN election processes for such predecessor funds, the resulting side letter can be cumbersome and unnecessarily lengthy. Lengthier side letters add costs to the drafting process, are more difficult to keep track of (and comply with), and lastly,lead to an increasingly cumbersome and expensive MFN election processes.

"Form" Side Letters

In order to keep costs down and simplify the MFN election process, it will often make sense for a general partner to create a "form" side letter that includes the general partner's preferred version of commonly requested side-letter provisions (e.g., MFN; affiliate transfer rights; LP advisory committee membership; fee breaks (if applicable); notification of material litigation and regulatory investigations; in-kind distributions; standard representations and warranties on good standing, due authorization, etc.; consent or notification rights for the establishment of alternative investment vehicles; credit facilities; co-investment opportunities; secondaries opportunities; tax withholding provisions; FATCA provisions, etc.). When investors and the general partner agree to include side-letter provisions in a side letter that address a specific issue, the general partner can use its pre-drafted provisions (revised or modified as necessary) in such side letter. Such provisions will typically be more beneficial to the fund/general partner than provisions that are initially drafted by the investors. In addition, such provisions will help streamline the MFN election process by minimizing the number of different side-letter provisions that address the same substantive issue.

Incorporation of Prior Funds' Side-letter provisions *into Fund Limited Partnership Agreements*

Another strategy for general partners to consider, particularly if there are predecessor funds in existence and significant investor overlap between the fund and the predecessor funds, is for the general partner to review the side letters for the predecessor funds and figure out what side-letter provisions, if any, might make sense to incorporate in the fund's limited partnership agreement. Those provisions can then be deleted from the side letters. A general partner might want to do the foregoing because it expects that a significant number of actual or prospective investors in the fund will ask for the same provisions in their side letters. Including the substance of such provisions in the fund's limited partnership agreement eliminates the need to include such provision in the side letter.

General Strategy Regarding Investors Eligible for Specific Side-letter Provisions

It may also make sense for fund managers to consider their general strategy for side-letter requests, and more specifically which provisions a general partner should be prepared to give to which investors. For example, a general partner could decide that it will not offer side letters to investors making capital commitments below a certain minimum threshold, or that it will only give those investors certain basic side-letter provisions. The general partner could also decide that only investors above a certain size might receive the benefit of certain other provisions, e.g., LP advisory committee seats, management fee reductions, or co-investment rights. Even though the criteria for making the decisions described above may shift during the fundraising process, it is helpful for general partners to have a policy or strategy in place for how to approach side-letter requests from prospective investors.

What Goes in the Side Letter vs. the Limited Partnership Agreement

In negotiating the terms of an investor's investment in a fund, an investor (and their counsel) will typically have

reviewed the private placement memorandum and limited partnership agreement for the fund in question. On the basis of that review, the investor or its counsel will have provided to the general partner comments on the commercial and legal terms of an investment in the fund by such prospective investor. Some of those comments will very obviously be items that, if agreed to by the general partner, need to be addressed in a side letter (e.g., LP advisory committee membership, use-of-name provisions specific to that investor, or provisions that address specific tax, legal, or regulatory issues that are unique to that investor, etc.). Other comments will pertain to items that require revision to, or amendment of, the fund limited partnership agreement (e.g., comments on keyman provisions, termination rights relating to the investment period or the term of the fund, GP removal provisions, and material changes to the investment program and investment parameters of the fund).

Generally, investor comments requesting changes in terms that affect an individual investor (as opposed to affecting the fund as a whole, or other investors in the fund), usually end up in side letters. Correspondingly, comments on fund terms that materially affect the rights of all investors or the fund as a whole usually end up being implemented through an amendment or revision of the fund limited partnership agreement.

There is a third category of investor comments consisting of provisions that may be included either in a side letter or in the fund's limited partnership agreement (e.g., certain reporting and notification rights, co-investment policies, confirmation of certain investment parameters or restrictions, additional restrictions imposed on the general partner or fund manager, etc.). The decision on whether to implement such provisions in the side letter or in the limited partnership agreement will depend on a variety of factors, including without limitation, the general partner's success in actually closing investors' capital commitments to the fund. For example, general partners may be more willing to modify limited partnership agreements when there are fewer or no investors in the fund than they would be after the fund has had a number of subsequent closings and is close to reaching its fundraising target. Additionally, an investor and the general partner may agree that a particular comment needs to be implemented in the limited partnership agreement. However, the general partner may be eager to have a closing that includes such investor without any additional delays that may result from having to notify, or obtain the consent from, existing investors to amendments to the fund limited partnership agreement. In this scenario, the parties may agree to a side-letter provision that provides that the general partner will use best efforts at some future date (e.g., promptly following the end of the fundraising period for the fund), to seek consent to such amendments from the fund's investors. In choosing whether to include a provision in a side letter instead of in a fund's limited partnership agreement, general partners should also take into consideration the fact that once a particular provision is included in a limited partnership agreement, it may be very difficult to delete such provision from the limited partnership agreements of successor funds (even if the investor that requested such provisions in the first instance is not an investor in such successor funds).

MFN Election Process

Best practice for the MFN election process is to require investors to make their MFN elections shortly after the end of the fundraising period. That way investors get to make a single set of elections as opposed to making multiple elections. Sometimes investors will ask to see redacted copies of the side letters of prior investors in a fund before they make their initial side-letter requests. Where possible, general partners should consider rejecting such requests, as they can lead to lengthier side-letter requests from investors that include provisions that are not really critical to such investors' investment in the fund.

With smaller funds that may not have a large number of side letters, the MFN election process may simply involve sending redacted copies of the side letters to investors and asking the investors to return such side letters after circling the provisions that they want. Often, the MFN provision itself may require all side letters to be sent to investors even if investors only have the right to elect to receive the benefits of provisions granted to smaller investors. In such instances, in order to avoid confusion, general partners should identify in their communications with investors, the side letters from which investors are eligible to make their elections.

For funds with larger numbers of side letters, the administrative burden of running an MFN process can be onerous. In such instances, instead of sending all side letters to investors it might make sense to send to investors (i) a "side-letter compendium" that sets forth the various side-letter provisions entered into in connection with the fund and (ii) an MFN election form

that lists or references those provisions that the applicable investor is eligible to elect.

OTHER ISSUES PERTAINING SPECIFICALLY TO HEDGE FUNDS

Many of the considerations set forth above are relevant when negotiating side letters for Hedge Funds, including creating a form of side letter on preferred provisions, having a general strategy as to your side letter negotiation process (e.g., how the size-based MFN will work and whether side letters will be only granted solely to address legal, regulatory, or tax issues specific to an investor), determining whether a specific request belongs in a side letter or in the fund documentation in general and the MFN process.

On the process side, one difference for managers of Hedge Funds is the need to interface with boards of directors of the offshore funds and governance/advisory boards for onshore funds. Hedge Fund managers need to ensure that these boards are kept apprised of side-letter negotiations, and have the opportunity to review and approve the letters prior to closing. Since Hedge Funds are often continuously offering, with capital often accepted at the beginning of a month, the negotiation process is typically in the weeks or days immediately prior to closing and, therefore, ensuring that the board members are available to review and approve becomes more critical at that time.

Another difference in approach for Hedge Fund managers relates to dealing with fiduciary issues related to liquidity and transparency. For managers newly launching a Hedge Fund, a more recent practice is to build an MFN provision directly into the fund documentation, as opposed to negotiating such provision in a side letter. One benefit of this approach is the manager is better able to set a level playing field in terms of negotiation and use its preferred MFN provision as to rights that are subject to the MFN. In essence, a built-in MFN, if carefully drafted, can be used as a shield against certain requests. Furthermore, it gives investors a sense of transparency in terms of the rights granted, as Hedge Fund managers are often faced with competing MFN requests that come with different rights and different methods of aggregating capital for "size-based" rights.

To also limit the number of requests a Hedge Fund manager may receive through side letters, it is often helpful to create a suite of reporting that will be uniform across the investor base, including the timing that such reporting will be distributed. This will often eliminate provisions such as timing and reporting of estimated monthly performance, final monthly net asset values, K-1 reporting, and audited financial statement delivery.

Finally, once a Hedge Fund is launched, careful attention has to be paid to provisions that would create the fiduciary tensions described above. There are three basic approaches that can be used based on the manager's bargaining power: (i) reject the requested provisions; (ii) amend the fund documentation to extend the rights to all investors; or (iii) draft the side letter in such a way that the right is granted to all investors through the side letter as opposed to the named party to the letter. This last approach can be used when the manager, from a timing perspective, will amend the fund documentation at a later date, but cannot amend prior to closing, or when this right will be granted to all investors only for so long as the investor who negotiated the right remains invested in the Hedge Fund.

COMPLIANCE

Finally, from a compliance perspective, whether you are a manager of a PE Fund or Hedge Fund, having a side-letter chart that tracks the rights given to investors becomes an important part of the compliance process to ensure that the legal obligations negotiated are fulfilled. Such provisions need to be shared internally with constituents in the firm's organization, including investment professionals (on investment restrictions), tax professionals, accounting, investor relations, and legal and compliance. The key is to ensure that all parts of the organization can carry out the terms negotiated with investors. ■