Side Letters: The Times They Are a-Changin'

A few observations on side letters, the process of negotiating a fund-raise and related regulatory developments.

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While customized reporting, confidentiality, tax and regulatory undertakings and, in some cases, economics have become common elements of the current private equity fund raising environment, it was not so long ago that an investor granted "most favored nation" treatment could expect to receive the same (or substantially the same) rights as all other investors. The MFN assurance was the "self-help" remedy in an unregulated market reserved for investors that could help themselves. An investor in a private equity fund would often have only one request: MFN treatment. Times have changed.

The MFN provision is a byproduct of the flexible private fund structure, the extended nature of a fund-raise and the desire to meet the particular needs of investors that are otherwise generally not appropriate for inclusion in the partnership agreement or because of the stage of the fund-raising and closing schedule. Although the typical partnership agreement provides that it may only be amended with the consent of a majority in interest of the existing investors, the modern partnership agreement also typically allows for the general partner to enter a "side letter" agreement that alters or supplements the terms of the agreement as between the general partner and an investor. Since a typical private equity fund raises capital over a period of time with multiple closings, a side letter is a convenient way to address the specific concerns of an investor.

The number and prevalence of side letter requests has increased exponentially in the last decade, a trend that reflects, among other factors:

- the more difficult fund-raising environment;
- globalization of the market and investor base;
- requests to address non U.S. tax and reporting requirements;
- increasing participation by state and local government plans, all of which have specific requirements imposed by their local law or governing boards; and
- regulatory burdens on investors such as banks and insurance companies.

Broadly speaking, an MFN provision allows an investor to elect to receive the same rights granted by the sponsor to the other investors. However, MFN provisions have evolved due to the desire of sponsors to limit the side letter burden to the specific facts of the requesting investor. In general, there are a few customary carve-outs to an MFN provision which reflect the fact that the operation of the fund would become impractical or unstable if all investors had the same rights. These include:

- the ability to be excused from certain types of investments mandated by one investor's policy concerns;
- the ability to appoint a representative to a fund's advisory committee;
- the ability to transfer an interest;
- the ability to disclose information received from the fund (whether to satisfy public disclosure or other legal requirements or to upstream investors in a fund of funds); and
- provisions that relate to the tax, legal or regulatory status of an investor not shared by the electing investor.

In recent years, carve outs based on size of investment, early bird discounts and co investment rights have become more common. Regardless of the carve outs, an important consideration from the investor's perspective is the ability to review all of the side letters whether or not the investor has the ability to elect the other side letter provisions.

The MFN process is generally handled in two ways. While some investors ask to see other side letters at the time of their investment and before they invest, more often the sponsor agrees that after the final closing of the fund it will distribute the fully negotiated side letters (or a compilation of all of the side letters that remove duplicative or repetitive provisions) to all of the MFN recipients. If the sponsor takes on the burden of collating the separate side letters and eliminating duplicates, the review burden on investors is reduced and the process efficiency inures to the collective good of all investors. While distributing side letters before a closing can alleviate investor concerns about "carve outs" it makes the closing process more protracted as side letter MFN requests need to be addressed in an iterative fashion and investors are often given insufficient time prior to closing to review other side letters.

For those sponsors "marketing" to investors in the European Economic Area, compliance with the Alternative Investment Fund Managers Directive may unwind the efficiency of the process described above.

Prior to the financial crisis and subsequent increase in regulatory oversight, the side letter process was bi lateral (i.e., limited to the sponsor and each investor). While this has evolved based on the interactions between market participants, the process is come under the scrutiny of the relevant regulatory agencies. As part of its disclosure mandates, the AIFMD requires disclosure to investors, prior to their investment, of the ability of the sponsor to provide alternative arrangements with investors, a description of the arrangements and the types of investors eligible to receive them. While the scope of the AIFMD limits the requirement to EEA domiciled investors, SEC fiduciary duty interpretations will generally require disclosure to investors of all material terms. The SEC has not mandated any specific disclosure of "side letters", however Form ADV (which is required to be filed with the SEC and is publicly available) does require disclosure of the compensation charged by the adviser. In addition, the SEC views the fiduciary duties imposed on an adviser under the U.S. Investment Advisers Act to include a duty of disclosure. As a consequence, sponsors typically disclose in their marketing materials and Form ADV that the sponsor may enter into side letters and those will only be available to the investors that negotiate for such rights. In light of fairness and taking into account the regulatory considerations, sponsors making disclosures to EEA investors may decide to make the same disclosures to all investors. In addition, in light of potential movement towards the "retailization" of private funds, sponsors should expect even more significant requirements surrounding side letters.

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