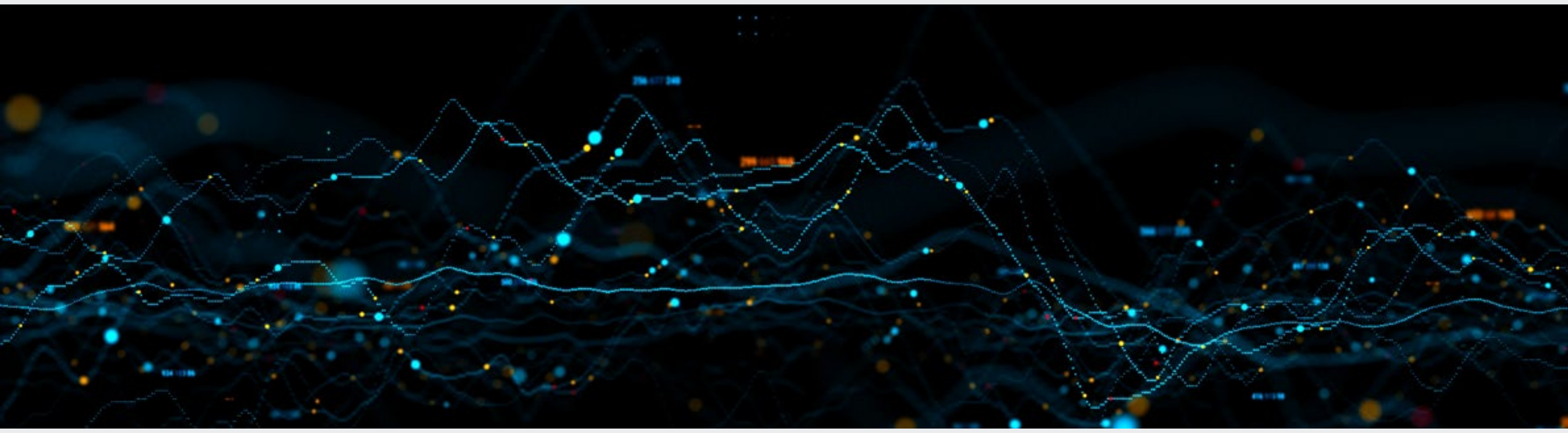
Side Letter Terms

Craig Borthwick
Partner
Dechert

Dona Treska
Associate
Dechert



Side letters form a contract between the investor, the fund and/or its manager that could alter the general contractual position of an investor under the fund's governing documentation. An investor may request side letter terms to cater for its bespoke regulatory and tax requirements or to obtain certain improved terms.

When negotiating side letters, it is important not to unduly expose the fund and the manager to regulatory, legal and operational risks. When seeking to accommodate an investor request, the fund and manager should seek to avoid those unduly restrictive or burdensome terms, including from a monitoring perspective (if side letter terms are not easy to monitor, there will be an increased risk of breach).

Overview of UK and EEA regulatory requirements

Managers based in the EEA or the UK (or managers based outside the EEA or the UK that market to investors in the EEA or the UK) that qualify as AIFMs are subject to AIFMD and must comply with certain regulatory requirements. In particular, AIFMD requires that all investors are treated fairly, and that any preferential treatment granted is disclosed to other investors. Such disclosure obligations have been broadly interpreted to require general disclosure in the fund's governing documentation the types of preferential treatment that might be granted to investors and to ensure that a description of any specific preferential treatment granted to an investor is made available to investors.

AIFMD also requires that any preferential treatment granted to an investor may not result in an overall material disadvantage to other investors.

Key side letter terms

Management and performance fees. Investors may seek lower management and performance fees than headline rates. These may be structured as a fee rebate in a side letter or implemented through establishing a separate class of shares (or interests).

Capacity rights. Investors may request the right to make additional investments in the fund on the same terms as their initial investment. The capacity right is typically expressed either as a maximum dollar amount or a percentage of the fund's net asset value. The right often extends to other funds managed by the investment manager (albeit the right should be excluded for managed accounts and 'fund-of-ones'). If the capacity of the fund's strategy is limited, a manager should seek to limit investors' capacity right to make further investments to avoid the concentration of the manager's investor base. If possible, capacity rights should also be limited in time and, if capacity is made available, the investor should be required to elect the use of such capacity within a certain period to allow the manager to offer such capacity to another investor.

Co-investment rights. Investors may request the right to participate in co-investment opportunities. A manager should seek to ensure that this right is restricted such that the investor is required to participate in such co-investment opportunity on the same terms made available to other participating investors and on a pro-rata basis.

Most favoured nations (MFN). Generally speaking, an MFN term requires that an investor is offered any preferential term which is offered to another investor. This is aimed at preventing another investor from receiving better terms of investment. If granted, the manager will need to actively monitor the MFN terms to ensure compliance. Managers should also seek to limit the MFN such that it does not negatively impact the manager's ability to raise assets from new investors. This might be achieved in several ways, including:

- restricting the MFN application to the fund in which the investor is invested (and funds and accounts with substantially similar strategies);
- restricting the application of the MFN to terms granted in respect of an amount invested which is, by value, the same as or less than the investor's investment in the fund;
- restricting the MFN to key investment terms, for example, fees, liquidity and transparency and avoiding a 'catch-all' MFN term. Any terms granted due to the specific nature of an investor (e.g. because of its regulatory or tax status) and which are not generally applicable to the other investors should be carved out from the application of the MFN term;
- requiring the investor to take the investment on the same terms and conditions (so as to avoid the investor 'cherry picking' the new investor's terms); and
- agreeing a forward-looking MFN by limiting its application only to future investors in the fund.

Redemption rights. An investor's investment could be subject to a lock-up period or relatively restricted redemption terms. If so, an investor may seek the right to redeem on the occurrence of certain material and adverse events, for example: (i) upon the occurrence of a key person event, if the key person has reduced their investment in the fund (or the strategy) below a certain amount, or if the key person or any member of the investment management business has been convicted of a dishonesty offence; (ii) if the manager materially breaches the fund documents or an active breach occurs with respect to certain investment restrictions; or (iii) there has been a decline in the fund's net asset value over a certain threshold.

It is essential that the manager ensures that any redemption rights are limited by reference to materiality and that if such terms are offered to an investor, they do not materiality disadvantage the interests of other investors, including in light of the manager's obligations under AIFMD. Accordingly, the investor's right to redeem should be stated to remain subject to the liquidity management terms detailed in the fund's constitutional and offering documentation (including, in particular, any gates, suspension rights and the right of the fund to redeem an investor in specie rather than in cash only).

Further, to the extent that the manager has agreed to disclose and offer redemption rights on the occurrence of certain events to an investor, it will be important to ensure that same is disclosed and provided to all investors where not doing so would lead to an overall material disadvantage to other investors.

Redemptions in cash. Investors may request that the fund agree to only make cash distributions on redemption, thereby removing the fund's power to make redemptions in specie. The request is often driven by the investor's own regulatory requirements or internal investment policies. Granting such terms should be avoided where to do so would result in unfairness to other investors (where remaining investors are left with illiquid assets whilst the investor(s) benefiting from the term would receive cash).

If requested by an investor, the fund and the manager should ensure that the fund retains the right to make distributions in specie where it is not reasonably practicable to make a cash distribution. Further, any such terms should remain subject to applicable law and regulation (which should assist the fund and manager in disapplying the right to receive cash where to do so would breach AIFMD obligations).

Transfer rights. An investor may request the right to transfer its investment without the consent of the fund or the manager, often to its affiliates. If given, transfer rights should ideally be limited to the investor's affiliates (or another pre-designated group), and any transfer should be made subject to the terms of the fund's governing documentation (such that the transferee is required to enter into transfer documentation and satisfy the eligibility criteria). Further, the transfer right should be disapplied where it would result in material adverse legal, tax, pecuniary or regulatory consequences to the fund, other investors and/or manager.

Transparency. An investor may require transparency and access to certain information that a manager would not otherwise offer to all investors (often to ensure compliance with any investment restrictions or guidelines). This obligation might include position-level transparency.

Granting preferential transparency rights risks breaching AIFMD requirements where transparency would allow an investor better access to information that might inform its decision to redeem from the fund ahead of another investor. Accordingly, to ensure such transparency does not create unfairness, the manager should either provide such transparency to all investors at all times or ensure that, if circumstances exist that would lead such transparency to cause unfairness, to ensure all investors have such transparency at that time.

Investment restrictions. An investor may specify that certain investments are not permitted to be held by the fund (typically for regulatory or tax reasons). Managers should ensure that agreeing to such restrictions does not unduly restrict the manager from fulfilling its stated investment strategy.

Regulatory and tax terms. Investors may request a variety of tax obligations and confirmations due to their specific circumstances. Provisions might include enhanced reporting rights and confirmations that the fund will be managed so as to avoid certain taxation consequences (such as the need for investors to file taxation returns in certain jurisdictions). Agreeing to such terms should be balanced carefully against unduly restricting the ability of the manager to pursue the stated investment strategy and not unfairly treating other investors.