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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.

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