

Compliance Corner

Hedge Fund Side Letters: Compliance Issues, Policies, and Best Practices

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Hedge fund managers are frequently asked to enter into side letters, which can be problematic in light of the enhanced scrutiny they have received from regulatory bodies and industry groups around the globe over the past few years. Side letters operate as a private agreement between a hedge fund manager and an investor, whereby the manager agrees to provide the investor with certain rights, representations, or information not otherwise available to other investors in the fund. Side letters have long been utilized by hedge fund managers as a tool to spur significant and strategically valuable investments in their funds. Side letters may also be used to maintain the confidentiality of favorable provisions in order to reduce the number of investors requesting the same terms. Side letters also are often utilized to address matters that arise just prior to the closing of an investment in a hedge fund in order to prevent delays associated with revisions to the fund's offering documents. While this article focuses on U.S. federal securities laws, due to the impact of the U.K. regulatory regime on international hedge fund best practices, a U.K. regulatory overview has also been provided.

U.S. Regulatory Overview

In the U.S., the terms of side letters came under significant, if short-lived, scrutiny during the term of the hedge fund adviser registration requirement under former Rule 203(b)(3)-2 of the Investment Advisers Act of 1940 (the "Rule"), which was implemented on February 1, 2006 and overturned on June 23, 2006 by the decision of the U.S. Court of Appeals for the District of Columbia in the case of *Goldstein vs. SEC*. Shortly after the implementation of the Rule, the SEC requested materials from newly registered hedge fund managers similar to those requested during mutual fund inspections, such as e-mails from advisers and trading and best execution policies and procedures. The SEC noted at the time that it was comparing disclosure in hedge fund private placement memoranda with materials reflecting how the offerings were actually managed in order to monitor for fraud.

During the era of the Rule, the SEC also reviewed side letters to determine whether appropriate disclosure of side letters and relevant conflicts of interests had been made to other investors. Susan Ferris Wyderko, former Acting Director of the SEC's Division of Investment Management, stated in 2006 that terms of little regulatory concern to the SEC staff included those that did not negatively impact other investors, such as those addressing the ability to make additional investments, "most favored nation," or "MFN," clauses, and management fee and performance compensation reductions. Ms. Wyderko noted that side letter terms deemed more troubling by the SEC staff included conflicts of interest presented by liquidity preferences and preferential access to portfolio information. Since 2006, terms in side letters that provide liquidity preferences (provisions that enable an investor to exit a fund investment early and thereby cause the fund to have reduced liquidity) are generally deemed to have a high likelihood of disadvantaging funds as well as their investors and are usually avoided. In addition, side letter terms that grant preferential access to portfolio information and could thereby enable the recipient to use the information in a manner that could disadvantage other fund investors are also generally avoided.

Despite the lower profile of compliance issues relating to side letters with the SEC since the Rule was overturned, side letters should remain on hedge fund managers' radar for at least two main reasons. First, a number of hedge fund managers remain voluntarily registered with the SEC, and it is presumed that the SEC will continue to review the side letters of registered hedge fund managers from time to time. Second, a growing

Continued on page 8

number of retirement and pension plans have been increasing their allocations to hedge funds. Many hedge funds rely on ERISA's "significant participation test," which exempts their assets from treatment as "plan assets" under ERISA if less than 25% of each class of equity interests in the fund is held by "plan investors." Managers of hedge funds that are not deemed "plan assets" are not regarded as a "fiduciary" of an ERISA plan or subject to the applicable provisions of ERISA. However, if a side letter arrangement provides rights to investors that are substantially different enough from those of other investors that they constitute a separate "class" of equity interests, the fund, depending on the composition of investors in each class, could be deemed to be holding the "plan assets" of benefit plan investors (which includes ERISA plans and certain other types of retirement plan accounts, such as IRAs). Thus, the hedge fund manager would be deemed an ERISA fiduciary with respect to each ERISA investor in the fund and become subject to the prohibited transaction rules under ERISA and Section 4975 of the Internal Revenue Code of 1986, as amended. Accordingly, hedge fund managers should consider whether potential side letters would trigger application of ERISA's plan assets rule and prohibited transaction rules, which could prohibit certain trading or operational practices.

U.K. Regulatory Overview

The SEC's interest in side letters followed that of the United Kingdom's Financial Service Authority (the "FSA"), the regulatory body with which all UK-based hedge fund managers must be registered, and the FSA has continued its monitoring of side letters to date. The Alternative Investment Management Association (the "AIMA"), a hedge fund trade body that represents 1,100 hedge funds, has set out guidance on side letters in consultation with the FSA and the UK-based Hedge Fund Working Group (the "HFWG") that requires that firms disclose to investors and potential investors the existence of side letters that contain "material" terms regarding the relationship between the hedge fund and the investor. Under the AIMA guidance and the best practices standards for hedge fund managers issued by the HFWG in January 2008, a "material" term is one that might reasonably be expected to provide an investor with the enhanced ability to redeem or make a determination whether to redeem its fund interests, and which might therefore put other investors at a material disadvantage with respect to the exercise of their redemption rights. Examples of side letter provisions generally viewed as "material" under this analysis include terms granting preferential redemption rights, "key man" provisions, redemption gate waivers, and access to portfolio information. The AIMA guidance makes clear that a term that would otherwise be regarded as material may not be if, in practice, it does not provide one investor with more favorable treatment (*i.e.*, if all investors are granted the same class of rights as granted by the material term). In the U.S., the President's Working Group on Financial Markets' Group Report on Best Practices for the Hedge Fund Industry issued in April 2008 echoed the AIMA guidance, noting that hedge fund managers should disclose material terms such as enhanced control rights, preferential liquidity/redemption rights, "key man" provisions, redemption gate waivers, and terms that materially alter the investment program, as well as include a statement in the fund's offering documents as to whether preferential terms are made available.

Side Letter Compliance Policies and Procedures

Side letters clearly offer many potential benefits to hedge fund managers and may either benefit all fund investors by spurring a fund's growth or be of no material consequence to the other fund investors. However, they may present significant risks that a manager will have an incentive to: (i) offer rights to certain investors that may be detrimental to the fund or to other investors; (ii) change the nature of the investment being made by other investors; or (iii) materially change the fund's business model. Consequently, the manager may inadvertently find itself in violation of its fiduciary or contractual duties under the fund's agreements.

In order to prevent compliance violations with respect to side letters, hedge fund managers should keep in mind their fundamental obligation to place the interests of the fund and its investors first and should recognize that they owe a fiduciary duty to every investor in the fund. Hedge funds and managers should disclose any material conflicts of interest related to the fund and/or its investors and, as a preliminary matter, the fund's offering documents should accommodate the creation of side letter arrangements and investors should be informed when side letters may be granted. Each side letter provision should be closely scrutinized by the hedge fund manager and counsel from the perspective of other fund investors. Managers should monitor each side letter

Continued on page 9

to determine whether certain rights granted to investors can automatically become available to other investors with side letters that have a “most favored nation” provision, which entitles them to all of the rights granted to other investors via side letters. In addition, hedge fund managers should be aware that if other investors might reasonably claim that their interests could be materially harmed by a particular provision in a side letter, the provision is probably inappropriate for a side letter.

Hedge fund managers should review their compliance policies to determine whether the following recommendations have been considered:

Key Compliance Considerations

- Hedge fund managers (and, where relevant, hedge fund boards of directors) should ensure that a fund’s organizational documents permit (and the manager’s Form ADV, if applicable) side letter arrangements and that the fund’s offering documents disclose the existence and material terms of such side letter arrangements;
- Hedge fund managers (and, where relevant, boards) should consider their fiduciary duties to all investors when considering side letter terms;
- Hedge fund managers (and, where relevant, boards) should consider in each proposed side letter whether a separate class of shares should be created for the investor;
- Side letters should be approved by a directors’ resolution and reviewed by fund counsel;
- Side letters should be reviewed to ensure that they do not conflict with applicable law or prior fund agreements, including the fund’s organizational documents, offering documents, and previous side letters; and
- Side letters should be reviewed to ensure that they do not change the regulatory status of the fund under the “separate class” tests for measuring the percentage of ERISA assets invested in the fund.

Best Practices

- Hedge fund managers should consider early in the planning stages of the fund what side letter provisions might be granted and might consider a template side letter to send to investors that are interested in a side letter;
- Hedge fund managers might consider showing the terms of all side letters to any investor upon request;
- New hedge funds should be created with the flexibility to create and issue new share classes (due to the fact that all shareholders must be treated identically in certain jurisdictions);
- Hedge fund managers should actively monitor side letters with MFN provisions (or other side letters granting similar provisions) on an ongoing basis;
- Hedge fund managers should ensure that the fund administrator receives notice of side letter arrangements; and
- If a side letter creates fiduciary concerns with respect to other investors, hedge fund managers should consider creating a separately managed account for the investor requesting special terms.

Terms to Avoid in Side Letters

- Terms granting special liquidity terms such as short redemption notice periods, lockup waivers, or an ability to redeem on special terms in the event that certain events occur;
- Terms that change the manner in which a hedge fund generally operates;
- Terms that would waive indemnities provided to the hedge fund in its offering documents; and
- Terms that would provide investors with notice of certain circumstances, such as personnel changes, unless all investors are notified at the same time.

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