

New Frontiers in Hedge Fund Due Diligence
March 19, 2007

Morgan Lewis

Due Diligence Concerns with Side Letters

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Due Diligence Concerns with Side Letters

- Common Use of Side Letters
- Side Letter Provisions
- Regulatory Landscape
- Manager Procedures
- Questions to Ask

Common Use of Side Letters

- How side letters are used
- Side letter negotiation
- Constraints on use of side letters
 - Operative fund documentation
 - Contractual arrangement
 - Risks of creation of separate classes

Side Letter Provisions

- Representations about Manager's background or practices not affecting the Fund
 - Acknowledgment of fiduciary status & fiduciary responsibility of Manager
 - Availability of Manager for meetings
 - BCP of Manager
 - Insurance
 - Absence of disciplinary matters
- Undertakings covered by the OM
 - Audits/books
 - Provision of reports and audited financials

Side Letter Provisions

- Notification of material events
 - Notice of key staff changes
 - Claims & litigation
 - Bankruptcy
 - Board invoking rights to indemnity
 - Fund being subject to ERISA plan asset rules
- Transparency rights
 - Concentration, exposure & risk
 - Holdings specific information
- Waiver of transfer and redemption limits
 - Transfers to affiliates
 - Reduced notice
 - Ability to redeem on material events
- Fee Waivers
 - Management and Incentive Fees charged by Manager
 - Redemption Fees
- Confidentiality

Side Letter Provisions

- Governing law – Application of investor's choice
- Indemnification
- Records - Inspection & maintenance for specified periods
- Ownership of client reports
- Distributions in-kind
- Tax issues
- Investment restrictions (e.g., limits on holding illiquid securities)
- Limits on investor's percentage ownership of a Fund
- Dispute resolution (e.g., arbitration)
- MFN

Regulatory Landscape

- SEC Guidance
 - Side letter terms raising few concerns
 - Side letter terms SEC finds “troubling”
 - Scope of disclosure
 - Fiduciary duty issues

Regulatory Landscape

- UK Financial Services Authority Guidance
 - Disclosure requirements (existence of side letter vs. nature of side letter)
 - Failure to disclose is breach of Principle 1 of FSA Principles for Business
 - Management of conflicts

Regulatory Landscape

- UK Alternative Investment Management Association (AIMA) Guidance
 - Who is required to disclose?
 - What has to be disclosed?
 - What is a material term?
 - How must the disclosures be made?
 - How often must the disclosures be made?

Manager Procedures

- Approval of Side Letters
 - Delegated authority
 - Conflicts
 - Separate classes
- Disclosure
 - OM and ADV disclosure
 - Reporting
- Monitoring Adherence
 - Conflicting side letters and MFNs

Questions to Ask

- Kinds of side letters
- Procedures for approval
- Approach to conflicts in side letters
- Disclosure and reporting

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