

REINHART

E-NEWSLETTER

ATTORNEYS:

Steven D. Huff
Keith L. Johnson
Benjamin G. Lombard
Delos N. Lutton
Martin J. McLaughlin
Albert S. Orr
William P. Schultz
Jussi P. Snellman

1000 North Water Street
P.O. Box 2965
Milwaukee, Wisconsin
53201-2965
414-298-1000
800-553-6215

22 East Mifflin Street
P.O. Box 2018
Madison, Wisconsin
53701-2018
608-229-2200
800-728-6239

W233 N2080
Ridgeview Parkway
P.O. Box 2265
Waukesha, Wisconsin
53187-2265
262-951-4500
800-928-5529

2215 Perrygreen Way
Rockford, IL
61107
815-633-5300
800-840-5420

Reinhart Institutional Investment Issues Alert

11/08/2006

USE OF SIDE LETTERS IN PRIVATE MARKET FUNDS

Side Letters are agreements between an individual fund investor and the fund manager. They are separate from the overall fund documentation and are commonly used by investors in private equity funds and hedge funds to obtain specific terms not provided to all investors. Over the past six months, regulators on both sides of the Atlantic have strongly objected to funds' using undisclosed side letters that could have the effect of favoring one investor at the expense of another. As a result, disclosure to all investors of side letter terms involving potential material conflicts of interest is now required.

A. **Initial UK Position (FSA): Disclose All Side Letters to All Investors.** The first side letter regulatory guidance came from the United Kingdom's Financial Services Authority ("FSA") in March 2006. In Feedback Statement 06/2, entitled "Hedge Funds: A Discussion of Risk and Regulatory Engagement" ("FS06/2") FSA stated:

Secondly, we believe that a market failure may be present regarding the use of side letters (see our response to Question 8 dealing with due diligence and disclosure). These result in some, often large, investors receiving more information and preferential (early) redemption terms compared with other investors in the same share class (who may be unaware that side letters exist and who will be denied these terms). We believe that failure by UK-based hedge fund managers to disclose the existence of these side letters is, amongst other potential breaches, in breach of Principle 1 of our Principles for Businesses (a firm must conduct its business with integrity). As with valuation abuses, we will take action on this basis. *As a minimum we would expect acceptable market practice to be for managers to ensure that all investors are informed when a side letter is granted and any conflicts that may arise are adequately managed.* Managers that fail to inform investors will need to carefully consider their position. (Emphasis added.)

Thus, FSA's March 2006 position and the official FSA position is to require disclosure of all side letters to all investors.

B. **US Position: Some Side Letter Terms Must Be Disclosed to All Investors.**

Two months after FSA issued FS06/2, the SEC provided testimony² to the U.S. Senate in which it made clear that (a) the SEC has no objection, and

does not require disclosure of, most side letter terms, and (b) the SEC does object, and does require disclosure of, side letter terms that "may involve material conflicts of interest that can harm the interests of other investors." The SEC offered the following guidance as to what such objectionable terms might be:

No Potential Conflict of Interest / No Disclosure Required	Potential Conflict of Interest / Disclosure Required to Investors
<ul style="list-style-type: none"> • Ability to Make Additional Investments • Nations Provisions • Limit Management Fees or Incentives / Fee Rebates 	<ul style="list-style-type: none"> • Liquidity Preferences / Preferential Redemption • More Access to Portfolio Information/ Transparency

C. **Revised UK Position: Same Disclosure as SEC Position; Retroactive Disclosure Obligation.** On September 27, 2006 the Alternative Investment Management Association ("AIMA"), an industry trade group for hedge funds, apparently after working closely with the FSA, issued an Industry Guidance Note regarding FS06/2. According to the Industry Guidance Note, the FSA has "reviewed [the Industry Guidance] and will take it into account when exercising its regulatory functions" - although the Guidance Note is "not FSA guidance and, in the event of any conflict, the FSA Handbook prevails."

1. **Required Disclosures.** AIMA's Industry Guidance Note articulated a position similar to, and overlapping with, that of the SEC. Disclosure is mandatory for material side letter terms that have potential to create conflicts of interest. Specifically:

No Potential Conflict of Interest / No Disclosure Required	Potential Conflict of Interest / Disclosure Required to Investors
<ul style="list-style-type: none"> • Most Favored Nations Provisions • Limit Management Fees or Incentives / Fee Rebates 	<ul style="list-style-type: none"> • Liquidity Preferences / Preferential Redemption • More Access to Portfolio Information / Transparency • Shorter notice period for redemptions • Key person provisions

2. **Look-Back / Retroactive Disclosure Required.** AIMA has an October 31, 2006 deadline for funds to make disclosure to all current investors - no matter what the date of their investment - of all material side letter terms. This disclosure applies with respect to side letters that have been entered into previously, as well as on a going-forward basis.

3. **Type of Disclosure Required.** Unlike the SEC and FS06/2, AIMA provides highly specific guidance as to the required form of disclosure. Firms should give a brief description of material terms contained in side letters which have been entered into (for example: "we have entered into side letters with investors, which contain material terms which: (a) grant preferential redemption rights; (b) contain a "key man"

provision; (c) [etc]"). Firms are not expected to disclose the number of side letters, the dates on which they were entered into or the parties to them. Where side letters containing material terms have been entered into with investors whose shareholding or interest, individually or in aggregate, is significant (i. e., in excess of 10%), firms should consider highlighting this fact. It is significant that AIMA does not require the specific provision to be disclosed to the investor; rather, it is sufficient to provide a generic description.

D. **Applicability to Reinhart Clients.** These developments are important for Reinhart clients - both in the private equity, real estate fund and hedge fund arena - on several fronts.

1. **Underlying Trend / Full Disclosure.** The trend is for greater disclosure to investors of side letter provisions. In light of the trend, "best practices" for fund managers may be to disclose all side letter terms. Additionally, fund managers will need to consider whether the best course of action is to provide a generic summary, the actual language, or both, with respect to side letter provisions that are subject to disclosure. Investors will typically want full disclosure of all side letters.

Additionally, fund managers will have to consider whether to offer a most-favored nations clause automatically, to all investors. (It is our experience that this is the practical reality for investments by sophisticated investors in investment partnerships.) Consideration may be given to including commonly granted side letter provisions in the limited partnership agreement to simplify compliance with the new disclosure obligations.

2. **Disclosure Mechanics.** Fund managers will need to be systematic about making required disclosures. Disclosure systems can vary in complexity, from (a) an automatic most-favored nations provision for private equity clients, to (b) a detailed disclosure regime for hedge funds that experience turnover of investors.

3. **Use Same Language In All Side Letters.** Fund managers will enjoy a simpler disclosure and recordkeeping scheme by offering consistent side letters to investors. Whenever possible, e.g., use the same "information disclosure" provision for all investors, rather than multiple individually crafted "individual disclosure" provisions. In many instances, fund managers may be encouraged to incorporate provisions into the partnership agreement or other primary fund documents that have historically been relegated to side letters.

4. **Disclose Certain Side Letter Terms Not Addressed By SEC, FSA and AIMA.** The SEC, FSA, and AIMA guidance is silent as to numerous other terms that frequently appear in side letters, and that also involve potential for conflicts of interest. There may never be an official pronouncement, or even an informal agency position, on whether disclosure of such terms is required. A prudent fund manager will therefore disclose such terms. Examples include:

- Advisory Committee Representation Rights (*Could affect informational rights of investors*).
- Distributions in Kind (*Sale by general partner of an investor's share in an investment (in lieu of in-kind distribution)*) could depress the price received by other investors who

attempt to sell their share of the investment directly).

- Right to co-invest (*can have material bearing on returns and capital utilization*).
- Right to invest in follow-on fund (*can be a material right, especially if size of follow-on fund is capped and other partners are excluded*).
- Mandatory notice of certain events - e.g., bad acts, bankruptcies, investigations, regulatory matters, and even actions by other investors (*can provide certain investors an advantage over other investors*).

E. Specific Concerns for Investors in Funds. These side letter developments are especially important for Reinhart clients that invest in funds - both in the private equity funds, real estate funds and hedge funds:

- **Disclosure of Provisions to Other Investors.** If our client receives the benefit of a "disclosable" provision, the client also should confirm that the fund will notify other investors that it has entered into the side letter provision with us. The reason: if such notice is not provided, the fund or the general partner may be subject to lawsuit by other investors for violation of fiduciary duties and, such a lawsuit could (1) result in the side letter provision not being enforced; (2) directly reduce the investor's returns; and (3) distract the general partner from investment activities.
- **Most-Favored Nations Provision.** We generally request on our clients' behalf that the fund provide a most-favored nations provision, or at a bare minimum, if we are a relatively small investor, copies of other investors' side letters. The recent regulatory guidance regarding disclosure of side letters should motivate recalcitrant funds to comply with these requests.

To discuss this Client Update further, please contact
Jussi Snellman at 608-229-2243 or jsnellma@reinhartlaw.com
or Keith Johnson at 608-229-2200 or kjohnson@reinhartlaw.com

¹While most of these publications have been in the hedge fund context, we believe that private equity, real estate and venture funds should also comply with these pronouncements. This is because (1) FSA has expressly stated that its pronouncement applies to all firms, including hedge funds managers (FS06/2 page 23), and (2) hedge fund, real estate and private equity fund investing in many cases involves significant convergence and overlap.

²Testimony Concerning Hedge Funds, by Susan Ferris Wyderko, Director, Office of Investor Education and Assistance, U.S. Securities & Exchange Commission, May 16, 2006.

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