



Allison Nolan is the founder and managing director of Athena International Management, a boutique governance provider offering experienced independent directors to the international investment management community. From her background as global head of funds & investment services in a leading offshore law firm, and her commercial and transaction management experience, Nolan has developed a wealth of expertise in the international financial services arena and has extensive knowledge of the legal and regulatory framework in the Cayman Islands and other offshore jurisdictions.

Side letters in the Covid-19 environment

Allison Nolan of Athena International Management highlights the renewed importance of side letters in 2020

In these unprecedented times, the use of side letters has taken on a new level of importance. At Athena International Management, as independent directors serving on the boards of myriad different fund structures and strategies, we are seeing this play out in two different respects. First, the side letters already in place require scrutiny to ensure compliance with their terms in the current situation. Second, and more importantly for capital raising, we are seeing an increased demand for side letters as a pre-requisite for substantial investments.

Side letters, the basics

A side letter is typically an additional agreement between certain investors and the fund that is separate and distinct from the original subscription agreement, offering memorandum and constitutional documents of the fund. Usually these side letters are with a larger strategic investor. There are many reasons why they are put in place, but often they are entered into to accommodate specific tax or regulatory concerns based on the type of investor, such as a pension plan, a sovereign wealth fund, an endowment and so on.

Outside of those investor-specific legal, regulatory and tax issues, we also see side letters that are designed to override certain provisions of the offering document. Large investors or strategic investors are seeking enhanced terms such as fee concessions, preferential access to information, additional reporting or generally enhanced transparency. And then there's most favoured nation (MFN) treatment.

MFN Provisions

The MFN provision is the key term in most side letters. MFN provisions are a popular device by which investors can en-

sure that they will be entitled to the benefit of more favourable terms which the fund may agree (with other investors) in the future.

There are a few things to consider when negotiating MFN provisions and some different ways to narrow down and restrict these:

- Attempt to restrict the MFN solely to the fund in question, so that future funds, managed accounts or other existing funds managed by the same manager are not included in the ambit of these.
- Structure the MFN to apply to prospective investors only; in other words, so that the provisions only apply going forward after that large investor has joined the fund.
- Restrict the MFN provisions so that they only apply to investors that are the same size or less. In some instances, when this provision is in place, the MFN will give the initial MFN investor the opportunity to match the terms of larger investors coming in by topping up their holding and thereby receiving the same terms.

It is customary, and important, to carve out investments made by the principals of the manager, their family members, trusts or any kind of tax or state planning vehicles for their benefit. This is crucial in terms of recognising arrangements where no fees are charged to the principals of the manager.

Finally, a fund and its investment manager should be aware that granting extremely preferential terms to early investors might put the fund in an undesirable position when negotiating terms with later-stage investors who seek MFN clauses.

Managing side letter risk with independence

It is important that the investment manager informs the directors of all proposed side letter arrangements and gives the directors the opportunity to review the terms of these side letters in advance. The directors should consider their fiduciary duties in carrying out the review, which include acting in the best interests of the fund as a whole. The duty is owed to the fund itself and the effect of this is that the directors should not consider solely the interests of a specific shareholder or the investment manager in determining whether to enter into the agreement.

This is where having knowledgeable, professional independent directors on board really adds value to the process. Experienced directors will have seen and be familiar with a variety of side letter provisions and can assist in navigating the key terms. This is no substitute for legal advice, and the directors, particularly those with a legal background, will be able to identify issues to refer to outside counsel. An example of such an issue that we sometimes see is where the side letters override certain terms of the offering document. When dealing with Cayman Islands companies, care should be taken that there is nothing in the side letter agreement that purports to override the provisions of the articles of association of the company.

Disclosure

The fund's legal advisers will also need to evaluate whether appropriate disclosure of the side letters and relevant conflicts has been made. Care is needed to ensure that they don't offer unfair advantages over other investors in the fund and independent directors are ideally placed to deal with such competing interests. This is of particular interest to regulators; the SEC has recently focused on this in examinations where side letters establish special terms, including preferential liquidity terms, but did not provide adequate disclosure about these side letters. Similarly, the FCA requires disclosure of the use of side letters and that a description of the material terms must also be disclosed.

Execution

The directors of the fund should ideally approve the terms of the side letter and its execution in advance by way of a unanimous written resolution or in a board meeting. It should be made clear who should be (and legally is able to be) the signatory of side letter. Typically, the issues covered by a side letter require the fund to make representations,

which means that execution by at least one of the directors of the fund on behalf of the fund is critical in terms of enforceability. If the terms affect the investment manager – such as fee arrangements – or require representations or confirmations by the investment manager, then the investment manager should make such representations themselves and be a party to the side letter. In addition, when executing, care should be taken to date the side letter – an important point in any event but especially when dealing with forward-looking MFN provisions.

Side letter matrices

It is imperative for funds to have a side letter matrix setting out the key terms of side letters. The matrix should make it clear who is responsible for the fund's adherence to the side letter terms and these registers are key for monitoring this. There may be obligations that fall under the ambit of the fund's administrator in practice and other items where, for example, the investment manager has certain additional reporting requirements.

Reporting

Throughout the life of a fund, an important function of the directors' role is to oversee the fund's compliance with its stated investment policies and any restrictions. Investment managers sometimes commit to further restrictions in side letters and consequently it is good practice for the investment manager's report to the board at each regularly scheduled board meeting to include verification as to their adherence to these restrictions and also confirmation as to compliance with the terms of side letters.

The Covid-19 environment

In March this year, as the global pandemic unfolded, redemptions from hedge funds skyrocketed. This necessitated the review of funds' governing documents and the terms of any side letters regarding redemptions in order to determine what tools are available if restrictions on redemptions needed to be imposed. Since then, the pent-up demand from earlier in the year is resulting in hedge fund allocations rebounding. However, given the additional issues inherent in operating in the current Covid-19 situation, this remains a challenging capital raising market which, by its very nature, gives rise to an increase in the volume, length and complexity of side letters. Having experienced independent directors on board can assist fund managers in navigating the various issues involved in these and, in doing so, mitigate risk.