The Top 10 Terms in Side Letters

Today, growing fund documentation is generating a massive amount of work for general partners (GPs) who are tasked with managing a large, complex, and critical set of promises to their limited partners (LPs). Are you effectively managing it all?

1. FEES AND EXPENSES

Fees and expenses are the most important economic terms between GPs and their investors. They are also the most closely scrutinized by regulators, including the SEC. "By far, the most common observation our examiners have made when examining private equity firms has to do with the adviser's collection of fees and allocation of expenses," **the agency said**. The SEC's examination and scrutiny of fees and expenses provisions have largely focused on "**inadequate policies and procedures or inadequate disclosure**" by GPs. The SEC's own language speaks directly to the need for a comprehensive system to identify all relevant fee and expense provisions, assign accountability for deliverables stemming from the agreed language, and maintain a comprehensive audit trail of compliance with such provisions. Failure to do so can lead to regulatory scrutiny and fines, reputational damage, and loss of investor trust.

2. ENVIRONMENTAL, SOCIAL, AND CORPORATE GOVERNANCE (ESG) STANDARDS

Over the past decade, environmental, social, and corporate governance (ESG) issues have become **increasingly important to LPs** and, thereby, the firms who hope to raise capital from them. While the impact of ESG on fund documentation is very much in the early stages, an increasing number of LPs are asking their GPs to acknowledge their commitment to the UN-supported **Principles for Responsible Investment** (PRI) and to put those considerations into practice while making investments. **Many LPs are also insisting on bespoke ESG reporting requirements**. ESG reporting may prove especially difficult in the short-term as there is no widely adopted standard ESG reporting template. As ESG practice continues to evolve, GPs need to be ready to quickly adapt their policies and procedures and deliver on ESG promises made to their investors.

3. CO-INVESTMENT RIGHTS

Today, co-investment rights are a common feature of the private funds landscape as a growing number of LPs continue to express interest in and negotiate for the ability to participate in co-investment opportunities. The challenge for fund managers is administering a co-investment program that reflects the outcome of negotiations with LPs and does not prefer certain LPs. In recent years, an array of co-investment mechanics has evolved, ranging from broadly offering co-investment opportunities based on each investors' pro-rata contributions to the main fund to individual co-investment rights in side letters. Whatever the specifics may be, GPs must have a comprehensive system to administer their co-investment program and comply with the mechanics established in their underlying fund documents.

4. MOST-FAVORED-NATION CLAUSES

While most-favored-nation (MFN) clauses were once reserved for a fund's largest investors, they are now being requested by LPs with increasing frequency. The proliferation of MFN clauses has led to a complicated and expansive MFN election process that is often not completed until months or even a year after the final fund close. However, GPs must both administer the MFN process and comply with their fund documents throughout the entire life of the fund. The current MFN election process is a costly and time-consuming manual undertaking that often results in a "summary" document that is as long and complicated as the source documents themselves. As MFN processes continue to become more complex, GPs need a system in place to quickly memorialize MFN elections and manage LP obligations, regardless of where those obligations originate.

5. INVESTMENT RESTRICTIONS

This broad bucket of limitations has grown significantly in recent years and continues to expand, covering geographies, industries, and even specific types of products and services. Compliance with investment restrictions is essential to maintaining healthy relationships with LPs, especially key LPs who may have negotiated very bespoke investment restrictions or limitations. Before making an investment decision, GPs must have a comprehensive system to understand and analyze the full scope of investment restrictions agreed to by their firm. The result of a comprehensive investment restriction analysis may require entirely passing on a deal, restructuring a deal to carve out certain LPs, or seeking LP consent before moving forward with a specific transaction.

6. KEY PERSON PROVISIONS

As much as asset management is about economic trends and financial analysis, it is also a people business. Key person provisions have long been included in both LPAs and side letters and are one of the most important terms in the fund negotiation process. In recent years, GPs have sought to make the key person event more difficult to trigger by negotiating to expand the total number of individuals at a firm required to trigger the provision. On the other hand, many LPs have sought to negotiate bespoke key person protections in their own side letters. This can lead to a patchwork of obligations – from individual notice requirements to management fee reductions – for GPs in the event a key person leaves the firm. GPs must be ready to act quickly and decisively at the occurrence of a key person event, as this will have implications for every stakeholder of the firm.

7. BESPOKE REPORTING REQUIREMENTS

LPAs have long contained a standard set of reporting requirements owed to LPs, including unaudited quarterly financial reports and audited annual reports. However, LPs are increasingly negotiating for additional financial and performance reporting. These requests include irregular deadlines required to comply with investors' internal requirements, monthly portfolio performance reporting, and custom metrics. This creates a significant amount of additional work, particularly for the GP's finance and accounting departments. Individuals tasked with delivering on LP reporting must have a comprehensive system to manage key deadlines, accurately deliver each report, and track compliance with bespoke requests across the LP base.

8. TRANSFER RIGHTS

The market for secondary fund interests is booming. AUM for dedicated secondaries funds grew from $12.2 billion in 2010 to a record $77.8 billion in 2020, **according to Preqin**. The growth in the secondaries market has led to increased scrutiny of the transfer rights provision of LPAs. While sales of LP interests in a fund typically require the consent of the GP, LPs are increasingly looking to take advantage of liquidity opportunities in the secondary market. For GPs, this not only means overseeing the sales process to ensure a smooth transfer, but they must now also manage the obligations owed to the secondary buyer, who may or may not have the same rights as the previous owner. This requires GPs to have a flexible system in place that allows them to quickly understand and act on all obligations owed to secondary purchasers of fund interests.

9. CONFIDENTIALITY

Confidentiality requirements have become increasingly onerous for GPs to manage, both with respect to the confidentiality of LP information and to ensure that LPs do not inappropriately disclose information about the fund. LPs often seek to negotiate bespoke confidentiality provisions that can prohibit a broad range of activities, including sharing a specific LP's side letter or side letter terms and even using the LP's name in conversations with third parties. Individual confidentiality provisions can create a patchwork of obligations that GPs must constantly manage. Failure to comply with confidentiality obligations, particularly for the most sensitive investors, can have real consequences for investor relations teams and future fundraising.

On the other hand, GPs typically negotiate for their own set of confidentiality obligations with their LPs. Certain LPs – especially public pensions, funds of funds, and other entities that have beneficiary reporting requirements – will routinely ask for waivers to confidentiality provisions to comply with their own reporting obligations.

To lessen the administrative burden, GPs need a strong process for tracking the confidentiality provisions they agreed to provide to their LPs while managing the consent process with LPs that need waivers on the GP confidentiality protections.

10. CAPITAL CONCENTRATION LIMITS

Similar to investment restrictions, capital concentration limits are negotiated to limit or control the percent of capital that can be placed in any particular geography, industry, or investment class. While this may be a good diversification practice, concentration limits are often demanded by LPs to ensure GPs adhere to certain investment goals and standards. As these concentration limits continue to evolve, particularly in the face of ESG, GPs must be able to quickly understand the concentration of their current portfolio, quickly assess relevant restrictions, and accordingly adjust their investment practices.