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The FSA, Hedge Funds and Side Letters—It's a Matter of Principle

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There is no specific FSA rule which prohibits hedge funds or their managers or other FSA-regulated firms from entering into side letters with selected customers. And there are no FSA guidelines as to the course to be followed if FSA-regulated firms choose to do so. Yet side letters have been one of the hottest topics of discussion in the hedge fund world since March of this year when the FSA strongly signaled its disapproval of side letters in its Feedback Statement FS06/2 – *Hedge Funds: A discussion of risk and regulatory engagement*.

As well as being a matter of regulatory concern in its own right, the side letters issue is an early example of an important change in the manner in which the FSA is regulating UK investment business – "more principle-based regulation."

More Principle-Based Regulation

The FSA has decided that more principle-based regulation is a better way to achieve its statutory objectives than detailed rules designed to set out the minutiae of everything which is prohibited and all that is permitted. The FSA considers that principle-based regulation is risk based and cost sensitive as well as being more flexible and future proof than detailed rules for regulating fast-developing financial markets and instruments.

A key reason for the more principle-based approach is the FSA's aim of continuing to improve the culture of compliance in the London market. Principle-based regulation is designed to increase the role of senior management in compliance with regulations. The FSA wants to ensure that compliance is not regarded as a matter for the compliance department to deal with. It wants greater senior management involvement in compliance matters.

Principle-based regulation is not new. The FSA's predecessor regulators established "principles for businesses" in the early 1990s and the SIB as well as SFA and IMRO relied upon them to bring enforcement proceedings both in addition to and instead of individual rules.

FS06/2: The FSA States Its Principle-Based Position

In FS06/2 the FSA did not mince its words in bringing the weight of its Principles to bear against side letters:

> "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 of Business ('a firm must conduct its business with integrity'). The Principles are a statement of firms' fundamental obligations. They apply to all firms and this includes hedge fund managers. We will take action against firms on this basis when needed. *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.* [Italics in original]. Managers that fail to inform investors will need to carefully consider their position. We have concluded that it is important to review these practices later in 2006. That work will enable us to take action against individual firms and their senior management if appropriate." (FS06/2, section 2.5, page 6; and see also passages on pages 23 and 31 of FS06/2 where the language from the beginning of the quote above to the end of the italicized language is repeated).

The FSA's statements caused concern throughout the London hedge fund management community. Particular concern arose from the fact that funds managed by an FSA-regulated fund manager will have entered into any side letters and not the manager itself.

The AIMA Guidance

In an effort to allay industry concerns, a working group drawn from members of the Alternative Investment Management Association (AIMA), the hedge fund industry association, entered into discussions with the FSA with a view to clarifying matters.

The result of the AIMA working group meetings with FSA was an AIMA Guidance Note (the "**Guidance**") which is available at http://www.aima.org/uploads/IndustryGuidanceNoteSideLettersPublic.pdf and which includes a supplement ("Supplement No. 1") issued by AIMA on October 24th. In addition to addressing the nature of the required disclosure concerning side letters, guidance is also given on its timing, methods and investors to be informed.

AIMA emphasised that the Guidance is not FSA guidance, although the FSA will take compliance with it into account in connection with its regulation of firms. Compliance with the Guidance does not affect the rights of third parties (*e.g.* investors) although for the present there can be little doubt that it establishes an industry standard of accepted practice.

The Disclosure Requirement

The Guidance sets out the disclosure requirement as follows:

> "Firms will be required to disclose the existence of side letters which contain "material terms", and the nature of such terms, where the firm is a party to the side letters or is aware that a fund of which the firm or an affiliated entity is the investment manager is a party to them. Firms will not be required to disclose the existence of side letters which contain no material terms."

Supplement No. 1 clarifies that the disclosure requirement applies only to a firm which is **both** (1) an FSA regulated discretionary investment manager which employs hedge fund techniques **and** (2) an "Authoritative Source of Information," which term is defined as entity which is primarily or exclusively responsible for generating the substance of information for fund investors on the investment strategy, risk profile and related matters affecting the relevant fund.

The disclosure requirement applies to an Authoritative Source of Information whether it publishes information directly to fund investors or indirectly through providing it to the fund administrator or another third party which in turn publishes the information.

The disclosure requirement does not apply to (1) firms which do not exercise any discretionary investment management authority over funds assets; (2) firms which are fund of hedge fund managers; (3) firms which **only** (a) market shares or interests in a fund and/or (b) execute trades for the account of a fund and/or (c) give investment advice in relation to the investment of a fund's assets.

The disclosure requirement does not apply to a firm which is a party to a side letter, but is not itself an Authoritative Source of Information, in circumstances where an affiliated investment manager is an Authoritative Source of Information. For example, where a non-UK affiliate of the firm is the Authoritative Source of Information.

What is a Material Term?

Since the key element in the disclosure equation is whether a side letter contains material terms, the definition of that concept is crucial. The Guidance states that a "material term" is:

> "Any term the effect of which might reasonably be expected to be to provide an investor with more favourable treatment than other holders of the same class of share or interest which enhances that investor's ability either (i) to redeem shares or interests of that class or (ii) to make a determination as to whether to redeem shares or interests of that class, and which in either case might, therefore, reasonably be expected to put other holders of shares or interests of that class who are in the same position at a material disadvantage in connection with the exercise of their redemption rights."

In less technical language: a material term is one which enables the side letter recipient to make a profit or avoid a loss in circumstances where other fund investors who do not receive the information promised by the material term, might not be able to do so.

Examples of common material terms include preferential redemption rights; notification of corporate and/or personnel and/or financial events before they are announced to other investors; portfolio transparency rights and provision of more frequent performance information.

When Must Disclosure Be Made?

Initial disclosure is required to be made by October 31st, 2006. Thereafter it must be kept up to date by reasonably timely disclosure of new categories of side letters containing material terms. The FSA has confirmed to AIMA that firms will satisfy the October 31st initial disclosure requirement where they make the relevant disclosure in their investor reports/newsletters which are sent out in early November 2006.

What Must Be Disclosed?

A brief description of material terms in side letters with current investors.

An example would look like this:

"We have entered into side letters with certain investors which contain material terms. The areas they cover are:

- The grant of preferential redemption rights;
- Notification of corporate and/or personnel and/or financial events before they are publicly announced; and
- Provision of more frequent periodic performance reports."

If the relevant material terms were agreed with one or more investors whose shareholdings total more than 10%, it is appropriate to state that as well.

According to the Guidance the following are not regarded as material terms by the FSA:

- "Most favoured nation agreements" i.e. if more favourable terms are offered to another investor these will also be offered to the side letter counterparty; and
- Fee rebates and other preferential fee agreements.

Firms are not required to disclose the number of side letters containing any particular material term, nor the names of investors which are party to such side letters, nor the date they were agreed.

To Whom Must Disclosure Be Made and In What Manner?

Disclosure must be made to existing and prospective investors. Funds which issue monthly reports to investors can use them to make the required disclosures. A statement in a fund's offering memorandum in the appropriate form can be used to make disclosure to prospective investors.

Some Conclusions

Regulated firms need to determine whether terms are material and if so how to disclose them (or otherwise deal with FSA's concerns) applying general principles including those set out in the Guidance.

Side letters are not prohibited but they must be used with care. The FSA has clearly announced that it does not like them. It has clearly cautioned that their use may potentially cause a fund's manager to be in breach of FSA's Principles for Business. So side letters should only be entered into with caution and after taking competent professional advice.

These conclusions apply, as a matter of principle, to all funds, not just hedge funds, although to date the FSA's focus in relation to side letters has been hedge fund managers.

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