

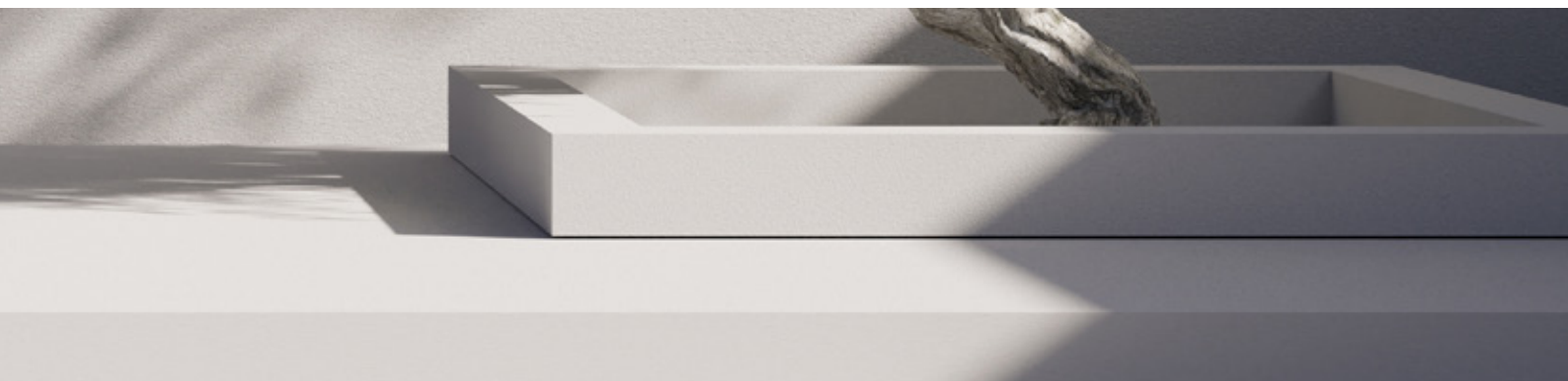


KIRKLAND & ELLIS



The fund manager's guide to side letters

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Preface



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Side letters have long been a significant element of fund formation processes. But as limited partners (LPs) have grown more sophisticated, and fund structures and documentation become more complex, there has been a consistent expansion of the use of side letters by LPs to secure tailored terms to address internal regulatory and policy requirements, supplement or clarify fund terms, and better align with their investment programs.

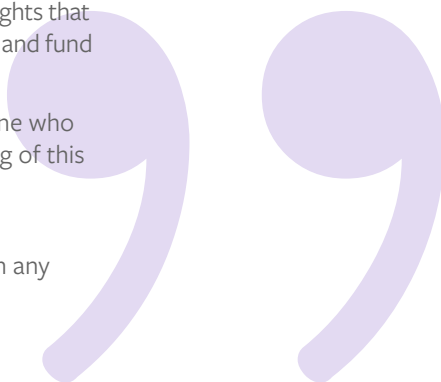
The breadth and complexity of modern side letter practices, however, has created significant compliance obligations for fund managers. Side letter compendiums can easily reach several hundred pages, and without careful consideration and planning, fund managers will struggle to satisfy all their obligations despite their best efforts. Side letter negotiations and implementation impact both fund operations and investor relations, and balancing standardization with a user-friendly investor experience can be difficult.

In this report, IQ-EQ and Kirkland & Ellis LLP explore certain critical factors fund managers should evaluate before agreeing to side letter provisions. Our aim is to provide practical insights that help mitigate risk while supporting effective negotiation and fund governance.

We would like to extend our sincere thanks to everyone who contributed their expertise and insights to the drafting of this guide. We hope you find the report both informative and actionable.

As always, our teams are available to support you with any questions or further guidance.

Benjamin and Justin



Executive summary

This paper, jointly prepared by IQ-EQ and Kirkland & Ellis LLP, serves as a practical guide for fund managers navigating the growing complexity of side letters in private fund formation.

It provides practical insights on operational challenges, compliance and regulatory considerations, the most common side letter provisions, and tech-enabled best practices for documentation, tracking, and ensuring confidentiality.

As LPs become more sophisticated and fund structures more complex, side letters (which serve to modify an LP's rights and obligations in relation to their investment in a fund) have expanded in scope and frequency. They're now a routine part of negotiations, especially for cornerstone investors and larger commitments, and are used to address regulatory requirements, adhere to internal policies, or set out bespoke investment terms.

While they provide flexibility and help secure commitments in competitive fundraising environments, they also introduce significant operational and compliance challenges. For example:

- **Administrative burden and complexity:** Managing hundreds of pages of bespoke terms requires careful planning and robust administrative processes. Bespoke and confidential side letters can also delay LP onboarding and increase legal costs
- **Impact on fund operations:** Tailored provisions can affect fund structure, accounting and reporting, often necessitating bespoke calculations and workflows – e.g. if the side letter alters economic terms for a specific LP, this may affect waterfall or carry models and require parallel tracking

The most common side letter provisions include:

- **MFN rights:** 'Most favored nation' (MFN) clauses ensure parity among comparable LPs but can create cascading administrative changes
- **Economic terms:** Fee discounts, reduced carry and hurdle rates are often negotiated based on commitment size or timing
- **Transfer rights:** Allow LPs to assign interests or pledge them under credit facilities
- **Reporting and disclosure:** Define the scope and frequency of financial, tax and regulatory reporting, as well as confidentiality obligations
- **ESG and DE&I expectations:** European LPs increasingly use side letters to formalize environmental, social, governance (ESG) and diversity, equity and inclusion (DE&I) priorities. LPs might request exclusion from investments in certain industries, or they may want enhanced reporting on aspects such as carbon footprint or board diversity

Regulators are attentive to fair treatment among LPs. Disclosure and robust compliance processes help mitigate risks. There are also various best practices that GPs can embrace to streamline onboarding and admin requirements while minimizing compliance burdens:

- **Standardization:** GPs are encouraged to standardize side letter provisions where possible, especially for common regulatory or policy requirements
- **Proper categorization:** Side letter terms should be reviewed and categorized at the outset to ensure compliance and avoid conflicting provisions
- **Technology solutions:** The use of specialized software and LP portal solutions is recommended for tracking, categorizing and securely storing side letter terms and related documents. Intelligent document processing tools can help screen and organize key provisions

Our report concludes that CFOs and COOs should ensure their teams are equipped to manage side letter commitments and the associated reporting and compliance costs. Managers must weigh each provision's broader impact, especially MFN clauses, and deploy technology to monitor and audit side letter obligations.

Introduction

Side letters are agreements between an LP and fund's general partner (GP) that are negotiated in connection with a private fund investment to modify, supplement or clarify the rights and obligations of such LP with respect to its investment in the fund. They are an important and useful tool for both the GP and the fund's LPs.

While there is no publicly available data on their prevalence, channel analysis indicates that side letters are increasingly common and that the scope and complexity of their terms and conditions are also expanding.

LPs often turn to side letters during fund commitment negotiations to document legal and regulatory requirements (such as compliance with the Freedom of Information Act and political contribution laws) as well as bespoke terms. This is especially common when the LP is a cornerstone investor in the fund but is also becoming more routine as the private fund asset class and LP investment programs become more sophisticated. In addition, for larger commitments, GPs may be willing to offer more customized terms via a side letter with the LP. [According to a 2025 survey of Institutional Limited Partners Association \(ILPA\) members](#), more than half of all LPs, and 69% of large LPs, reported more negotiating leverage with GPs compared to a year ago.

It should be no surprise that, despite the additional cost and complexity of negotiating and complying with side letters with numerous LPs in each fund, GPs are increasingly willing to entertain side letter requests to secure successful fundraises in today's challenging fundraising environment.

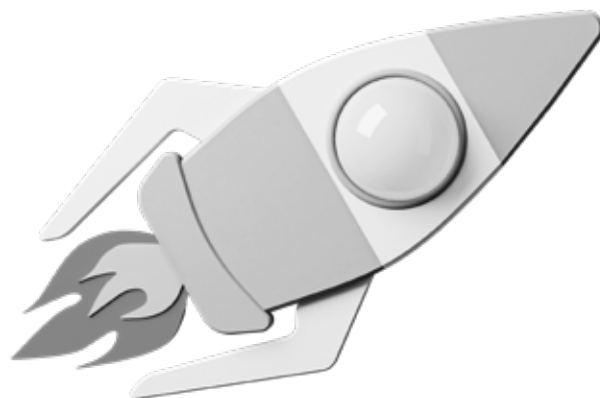
There are possibly competing operational goals for an LP and GP that can lead to surprising conflict. In particular, we know that many of the larger LPs – and often a fund's anchor or anchors – have a very “standard” side letter that they have neither the willingness or (limited) ability to negotiate because of specific regulatory or governance requirements. At the same time, GPs want broader standardization in their side letter language and internal operations as detailed in this fund manager's guide.

And, as we can attest, the energy around these can feel larger than warranted in the scheme of a specific fundraising. However, while a GP may be managing a handful of these hard-to-change standard side letters, the LP may have had these conversations with multiple GPs, day in, day out. Often, an LP's frustration is real when managing the pressure from internal mandates and the quite reasonable desire of the GP and their administrator to reduce complexity and save costs.

It's imperative, therefore, to have the LP-facing team understand these competing objectives, understand the LPs' truly non-negotiables and manage their internal stakeholders accordingly.



This paper will examine the use of side letters to provide practical insights for CFOs and COOs in the alternative markets.



Overview of side letters

Side letters are principally used to document requirements, terms and conditions that are separately negotiated by, and apply to, one specific LP (rather than items that apply to the fund as a whole), such as state law-mandated requirements for public pension plans, special notices and reporting, and excuse rights based on the particular regulatory circumstances of the LP.

As the private funds market has evolved (both in terms of product offerings and expansion of LP investment programs), LPs increasingly have bespoke needs for which they desire side letter rights.

It's also worth noting that many fund documents include a 'most favored-nation' (MFN) provision that gives each eligible LP the right to receive the same terms as other similarly situated LPs who negotiated more favorable terms in their side letter. This ensures some level of parity among comparable LPs; however, it has also resulted in the proliferation of side letter provisions that need to be tracked and managed.

The requested side letter provisions can vary from one LP to another (even when addressing the same topic), resulting in cumbersome reporting obligations and higher compliance costs to the fund – as discussed below.

For example, certain LPs require opt-out rights because they're not permitted to participate in investments in particular industries (e.g. alcohol, tobacco, gambling and firearms) based on their regulatory requirements or internal policies, whereas other LPs would not want to be excluded from such investments.

In addition, side letters are used to memorialize special terms or conditions, such as management fee discounts, co-investment rights or the right to appoint a representative to an LP advisory committee. These are often rights that are granted to LPs who agree to make significant capital commitments or come into the fund's first closing and are less frequently offered to smaller or later close LPs.

The use of side letters allows these LP-specific rights to be addressed without having to apply such terms to all LPs and without having to amend the main fund documents.



Operational considerations when entering into side letters

The growth of side letter usage has had a noticeable impact on the administrative teams of private markets firms. CFOs and COOs must oversee a rising volume of complex documentation specific to multiple clients, all while ensuring reporting and disclosure practices meet regulatory standards.

It's important to remember that side letter terms can have a fundamental impact on the administration of a fund's operations and even on the fund structure itself.

GPs should be very thoughtful about what is agreed to in a side letter, including consideration of broader implications on fund operations and potential impact on other LPs. Any tailored 'LP by LP' and even 'deal by deal' side letter provisions will add to a fund's operational complexity and make it less efficient to oversee than a single fund model. Side letters can also impact the fund's ability to transact with counterparties (e.g. subscription facility lenders), especially if they modify the GP's rights to call capital under the main fund documentation.

Any term change can affect the allocation of accounting transactions and disrupt the uniformity of approach when calculating LP account balances. This means that a fund's accompanying side letters require significant legal and accounting scrutiny and potentially the creation of bespoke reporting and accounting calculations for LPs. This internal review and vetting process can take time, which leads to a longer negotiation cycle, but it is critical to efficient fund operations.

As a result, GPs and their legal counsel should seek to standardize side letter provisions relating to a particular topic where possible to both streamline the LP onboarding process and minimize the compliance burden going forward. GPs should also recognize that LPs also desire standardized provisions for their investments for their own internal purposes, particularly for policy, state law and regulatory provisions that are less likely to be relevant to other LPs.

This should preferably be done early in the fundraising process and will often incorporate common provisions given in a predecessor fund. Form side letter provisions are especially helpful in connection with reporting, notice requirements, MFN rights and tax-related undertakings, where LPs want to know they are receiving the same treatment as other similarly-situated LPs, and GPs are able to consistently apply the provision (without having to analyze a redline of similarly – but not identically – drafted provisions to figure out if there are practical differences).

In addition, using standardized side letter provisions will make the MFN process more efficient by minimizing the number of different provisions that LPs need to review to make their elections. By increasing consistency among LP side letters, GPs can address LP needs while also improving efficiency and simplifying administration.

Best practices for documentation and tracking

Proper documentation and tracking of private equity fund side letters are critical for compliance, transparency and operational efficiency.

It can also help avoid potentially granting conflicting provisions to different LPs (e.g. agreeing with one LP to disclose all LP names, but agreeing with another LP that its name will be kept confidential).

Side letter terms need to be reviewed at the outset and properly categorized, as some terms will take effect immediately, e.g. an exclusion from participating in a fund's initial investment would need an allocation rule in the accounting system to ensure that any investment-related expenses for that deal don't get allocated to the excluded LP.

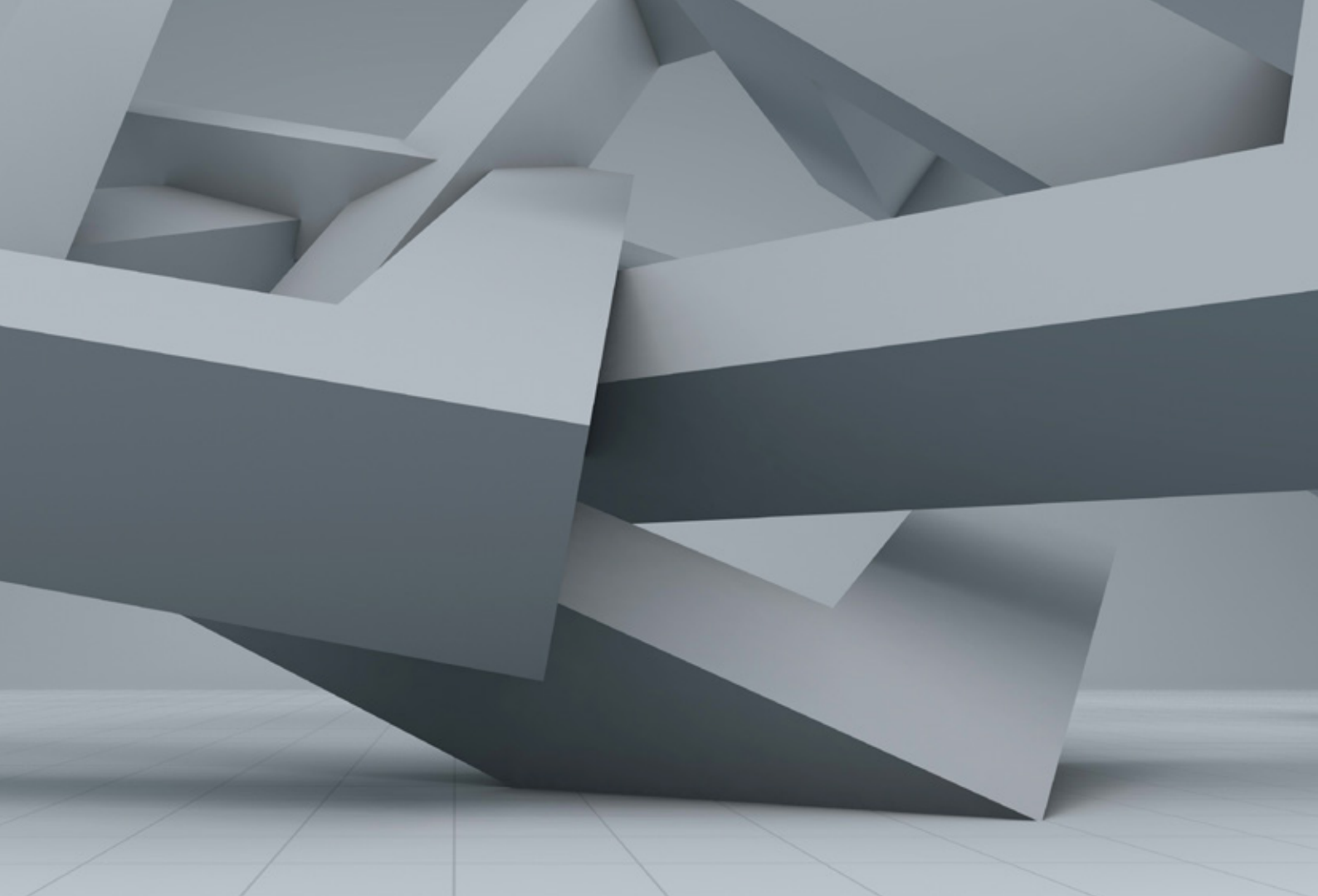
The good news is that there are an increasing number of software solutions specifically designed for side letter tracking that can help to screen, extract and categorize side letter terms and conditions and create follow-up workflows.

Such tools can also flag details considered complex or technical, ensuring that proper reporting conditions are in place.

Another resource to ensure best practice is an LP portal software solution. These can provide a secure, searchable document management system for LPs. Each LP is assigned a legal entity identity number to help ensure its side letter and other fund details are secured separately from other parties.

Portal access can be restricted and monitored, with users able to view an activity log. Documents can be assigned different levels of confidentiality to restrict access.

These tools ensure an audited record exists for review and help mitigate the single-point-of-failure risk that comes from having multiple client data points saved in one place.



Complexity in administration

The administration of private equity side letters is fraught with complexity and risk due to the bespoke and often confidential nature of these agreements. Many fund managers, particularly as they scale, face challenges in tracking, enforcing and complying with side letter provisions.

This can cause delays in the onboarding of LPs and increase the legal costs associated with each closing. It's important to establish a side letter strategy to manage this process.

One consideration is to use intelligent document processing tools to screen for and highlight key provisions. Clauses can be arranged into standard categories for reporting and compliance. This process also makes it easier to search the document or create actionable rules, especially pertinent when side letters have bespoke terms that might get overlooked if not properly catalogued.

LP side letters can also significantly impact the waterfall or carry model in a limited partnership agreement (LPA), particularly by altering the economic terms for specific LPs. These can be especially complex calculations to assess and need careful consideration.

For example, a side letter provision that reduces carry paid by certain LPs means a parallel waterfall model needs to be created, requiring separate tracking of distributions and separate calculations within each step of the waterfall.

Some of the most common provisions include:

MFN rights

- MFN rights give an LP the right to elect to receive the same terms as any other equally-sized or smaller investor who negotiates more favorable terms in their side letter
- This ensures parity and protects comparable investors from being disadvantaged relative to others who may have more leverage. However, MFN clauses can result in cascading changes across multiple investors when a right is granted – for example, a clause relating to reduced carry or increased hurdle rates could apply to multiple investors through the MFN, thus placing additional administrative burdens on GPs

Economic terms

- Fee discounts typically refer to a reduced management fee granted to certain investors, though on occasion a GP will agree to a reduced level of carried interest or a different hurdle rate. These discounts can be based on factors like the size of the investor's commitment, early participation or strategic value

Transfer rights

- Transfer rights allow an LP to assign its interest in the fund to an affiliate
- Sometimes an LP that has a net asset value (NAV) or other credit facility in place (such as a '40 Act fund) will require the consent of the sponsor to a pledge of its LP interest under such facility

Reporting obligations

- Reporting obligations that define what financial and operational information the private equity fund must provide to investors and how often. This can also include tax-related and regulatory reporting disclosures, such as details on income allocations, U.S. tax classifications, and withholding obligations

Disclosure of information

- This can include confidentiality obligations governing what LPs and GPs can share publicly about the operation of the fund and its investors and managers

Other common provisions relate to LP expectations around environmental, social and governance (ESG) and diversity, equity and inclusion (DE&I) factors, both of which remain important investing criteria for European LPs. These have evolved rapidly, and side letters are increasingly being used as a mechanism to formalise these priorities. As LPs seek to align their capital allocations with their values and regulatory obligations, fund managers must be prepared to accommodate bespoke ESG and DE&I provisions.

ESG commitments

- LPs may request exclusions from certain investments in industries (e.g. fossil fuels, tobacco, weapons)
- Side letter requests often include enhanced ESG reporting obligations, such as carbon footprint disclosures, sustainability metrics or alignment with certain frameworks

DE&I provisions

- DE&I-related side letter requests may include reporting on portfolio company hiring practices, board representation or supplier diversity

Operational implications

- ESG and DE&I provisions often require customized reporting and data collection, increasing the administrative burden on fund managers. The level of information available to a GP will vary widely based on the investment strategy (control buyout investments vs direct lending, for example)

Regulatory and reputational considerations

- GPs should ensure that ESG and DE&I side letter terms are realistic, measurable and aligned with the fund's strategy and capabilities



Compliance and regulatory considerations

Some regulators have scrutinized the practice of side letters, taking the view that select LPs shouldn't be given preferential treatment over others in the same fund if it would have a negative effect on the other LPs.

Fair treatment concerns may be mitigated if the side letter rights (either specifically or as to the category of rights) are sufficiently disclosed to LPs prior to making their investment decision – a practice that has become fairly routine across the private funds universe.

As with any contract, side letters can expose fund managers to claims of non-compliance or breach by LPs, though these tend to be rare. To ensure compliance with side letter obligations and help mitigate these risks, GPs should establish a side letter intake and review process involving legal, compliance, tax and investor relations teams. Side letter obligations can be integrated into task management tools to help GPs stay on top of the various requirements throughout the fund's life cycle.

Workflows can also be set up to trigger internal compliance checks and notify relevant departments of operational obligations, such as customized reporting or restrictions.

Periodic audits can be scheduled to ensure obligations are being met and that no contradictory or outdated terms exist.

Managing confidentiality and sensitive information

Ensuring LP details are securely handled is not just best practice; it's a legal and regulatory requirement. One option is to consider investor portal software that ensures individual LP data can be securely stored.

Access can be assigned via dual authentication. Information to and from the portal can be encrypted and secured by passcodes. Such processes reduce the chance of errors and block efforts by malicious actors to access confidential information to commit fraud or theft.



Conclusion

While side letter agreements can be a necessity for some LPs and a useful tool for GPs when negotiating new commitments from LPs during the fundraising process, they need to be monitored carefully. This requires a considerable administrative effort. Here's how to make that process easier:

- CFOs and COOs should first ensure they have the appropriate administrative capabilities to effectively manage the execution of side letter commitments and are prepared for the resulting cumbersome reporting and higher compliance costs to the fund
- Managers need to carefully weigh each side letter provision and its broader impact for LPs and on fund operations. MFN provisions can complicate the picture by creating a cascade of second order effects that need to be understood from the outset
- GPs should ensure processes to keep track of side letter provisions and actionable items. This may involve deploying a software solution to monitor side letter commitments
- Establish workflows so compliance checks and other operational obligations including periodic audits are not missed



How we can help

About IQ-EQ

IQ-EQ is a global, top-tier investor services group with an unrivalled offering to meet the administration, compliance and reporting needs of the private markets investment sector worldwide – including the enhanced administrative and reporting requirements involved in utilizing side letters.

Operating as trusted partners to our clients, we deliver intelligent solutions through a combination of well-honed technical expertise and strong relationships based on deep understanding. Our people-first services are powered by best-in-class technology including a global data platform and innovative proprietary tools supported by in-house experts.

We employ 5,900+ people across 25+ jurisdictions and have assets under administration (AUA) exceeding US\$857 billion. Our global client base includes fund managers, pension and sovereign wealth funds, family offices and multinational companies, and we work with 13 of the world's top 15 private equity firms. To find out more, please visit iqeq.com or get in touch with our expert team today.

About Kirkland & Ellis

With a global platform of approximately 4,000 lawyers in 22 cities across the United States, Europe, the Middle East and Asia, Kirkland & Ellis provides elite legal advice and a relentless commitment to client service.

Kirkland is a market leader in each of its core practice areas including private equity, M&A and other complex corporate transactions; investment fund formation and alternative asset management; restructurings; high-stakes commercial and intellectual property litigation; and government, regulatory and internal investigations. To learn more, please visit kirkland.com

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