



INTEGER WEALTH GLOBAL

Side Letter – Definition and Applications

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The ‘Side Letter’ Defined

A side letter option in funding refers to a special right or term granted to a specific investor through a separate agreement (a “side letter”) that sits alongside the main financing documents. It gives that investor an option-like privilege that other investors in the same round usually do not receive.

It is a preferential, optional right granted to a specific investor through a separate agreement, giving them future investment, liquidity, pricing, or control advantages not shared by all investors.

These are common in venture capital, private equity, and fund investments, especially when a lead or strategic investor has leverage.

1. What a Side Letter Is

A side letter is a legally binding agreement between:

- the company (or fund), and
- a specific investor

It modifies, supplements, or clarifies the main investment agreement only for that investor.

2. What ‘Side Letter Option’ Usually Means

A side letter option typically gives the investor an optional future right, such as:

a. Follow-on Investment Option

The investor has the right (but not obligation) to invest more capital in:

- future funding rounds, or
- a specific tranche, often at a fixed price or with priority allocation.

→ Example: Investor may invest up to £2m in the next Series B at the same price as new investors.



b. Pro-Rata or Super Pro-Rata Rights

While standard pro-rata rights are often in the main docs, a side letter option may grant:

- enhanced pro-rata (super pro-rata), or
- guaranteed allocation regardless of demand

→ This is common for cornerstone or strategic investors.

c. Liquidity or Exit Options

The investor may receive an option to:

- force a buyback after a certain date
- exit upon specific events
- participate early in secondary sales

→ Example: Company agrees to repurchase shares at fair market value if no exit by year 7.

d. Conversion or Pricing Options

An investor may get the option to:

- convert instruments on better terms
- receive MFN (most-favoured nation) protection
- adjust valuation if a later down round occurs

→ These are common with convertible notes or SAFEs.

e. Governance or Control Options

Though not always called “options” explicitly, side letters may grant conditional rights such as:

- option to appoint a board observer later
- veto rights triggered at ownership thresholds
- information rights beyond standard reporting

3. Why Side Letter Options Are Used

- To attract a key investor
- To reward a lead or anchor commitment
- To accommodate regulatory or internal policy requirements
- To preserve flexibility without rewriting core documents

4. Key Risks and Considerations

For founders and funds:

- Disclosure: Side letters often must be disclosed to other investors
- MFN clauses: Other investors may be able to adopt the same term
- Complexity: Too many side letters can complicate future rounds
- Fairness optics: Can create tension if terms feel overly preferential

For investors:

- Enforceability depends on precision of drafting
- Rights may be limited by future financing terms



Below is a side-by-side explanation of a side letter option from both the investor and founder perspectives, focusing on motivation, benefits, risks, and how each party typically thinks about negotiation.

Side Letter Options: Investor vs. Founder Perspective

1. How an Investor Views a Side Letter Option

The Core Mindset

"I'm committing meaningful capital or strategic value. I want downside protection and upside optionality beyond the standard terms."

1.1 Why Investors Ask for Side Letter Options

Investors usually request side letter options when they:

- Are a lead or cornerstone investor
- Are investing early and taking higher risk
- Bring strategic value (distribution, credibility, partnerships)
- Have internal fund constraints they must satisfy

To them, a side letter option is a risk-adjusted reward for committing early or heavily.

1.2 What Investors Gain

Upside Protection

- Options to invest more at known or favourable terms
- Super pro-rata rights to maintain or increase ownership
- Access to follow-on rounds before allocation fills

Investor thinking: *"If this works, I don't want to be diluted out of the winning outcome."*

Downside / Liquidity Protection

- Buyback rights if no exit by a certain date
- Priority access to secondary sales
- MFN clauses ensuring they're not worse off than later investors

"I need some path to liquidity in less-than-perfect outcomes."

Governance Visibility

- Optional board observer rights
- Enhanced information rights
- Consent rights triggered at certain thresholds

"I need oversight proportional to my risk and cheque size."



Investor Risks

- Side letters can be overridden by later financing documents
- Enforcement may be difficult if terms are vague
- Other investors may gain similar rights via MFN provisions

How Investors Negotiate

- Frame the option as **conditional** (“only if we invest X”)
- Emphasise **market standard for lead investors**
- Keep terms flexible but economically meaningful
- Avoid language that looks like control (to prevent founder pushback)

2. How a Founder Views a Side Letter Option

The Core Mindset

“I need capital now, but I must protect long-term flexibility and fairness.” Founders see side letter options as necessary trade-offs, not free concessions.

2.1 Why Founders Agree to Side Letter Options

Founders usually accept them when:

- The investor is critical to closing the round
- The option delays or avoids renegotiating valuation
- It helps attract other investors
- The right is future-dependent and non-automatic

Founder thinking: *“This doesn’t hurt today but could affect future rounds.”*

2.2 What Founders Benefit

Round Completion

- Secures a lead investor
- Signals confidence to others
- Reduces fundraising risk

Flexibility Today

- Keeps main documents clean
- Allows bespoke terms without reopening negotiations
- Avoids immediate dilution or valuation pressure

Controlled Optionality

If drafted properly:

- Rights can expire
- Rights can be capped
- Rights can be conditional on investor behaviour



Founder Risks (Often Underestimated)

Future Fundraising Constraints

- Investors with super pro-rata can crowd out new money
- Buyback options can scare later VCs
- Pricing options can distort future valuations

Fairness & Disclosure Issues

- Other investors may discover unequal treatment
- MFN clauses can multiply the concession
- Creates complexity in later rounds

“One side letter can quietly become five identical rights.”

Control Creep

What starts as ‘optional’ can later feel like:

- De facto veto power
- Soft pressure in board discussions
- Unequal influence among shareholders

How Founders Negotiate

Founders typically protect themselves by:

- Time-limiting options (e.g., expire after next round)
- Capping amounts or percentages
- Making rights non-transferable
- Tying options to continued ownership
- Ensuring consistency with future financing documents

“Optional, limited, temporary, and non-precedent-setting.”

3. Side-by-Side Summary

Aspect	Investor View	Founder View
Purpose	Risk protection + upside access	Close the round without conceding valuation
Leverage	Uses capital or strategic value	Uses optionality and limits
Main Fear	Missing out on upside or control	Future constraints or dilution
Ideal Outcome	Preferential flexibility	Minimal long-term impact
Negotiation Style	“Market standard for leads”	“Fine, but tightly scoped”



4. The Healthy Middle Ground

The best side letter options:

- Are **clearly defined**
- Are **conditional and time-boxed**
- Don't **bind future investors**
- Don't guarantee economics — only **opportunity**

5. The Plain Language Takeaway

- Investors see side letter options as insurance and upside reservation.
- Founders see them as a necessary cost — acceptable only if contained.
- The deal works when the option rewards early risk without handcuffing future growth.