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Liquidity

Schulte Partner Stephanie Breslow Discusses Hedge Fund Liquidity Management Tools in Practising Law Institute Seminar

By Jamie Sklar

"Liquidity" describes the frequency with which investors can get their money back from a hedge fund. Typically, the governing documents of a hedge fund contain default liquidity provisions and a set of mechanisms the manager can use to vary those default provisions. For example, the default provisions may say that investors can redeem from the fund quarterly, but the documents may also permit the manager to reduce, delay or recharacterize redemption requests. Conceptually, liquidity management tools are motivated by investment and equitable considerations: it is difficult to execute an investment program on a fickle capital base, and a manager's fiduciary duty flows to all investors in a commingled vehicle. In practice, however, investors are rarely happy to hear that they cannot get their money back.

Prior to the 2008 financial crisis, liquidity management tools in hedge fund governing documents were effectively viewed as boilerplate: present, but rarely used. Then credit markets seized up, liquidity dried up and everybody needed cash – investors for their own investors or beneficiaries, managers to satisfy redemptions, banks to remain solvent, etc. Managers blew the dust off long dormant provisions in governing documents and actually imposed gates, suspended redemptions and use other heretofore unthinkable techniques to manage liquidity.

The financial crisis has passed, but liquidity management remains an important topic in the hedge fund industry. Liquidity issues are often micro rather than macro, and, in any case, post-crisis documents have been drafted with a view to the next macro event. Recognizing the ongoing importance of liquidity management in hedge fund governance, Stephanie R. Breslow presented a session on the topic at the Practising Law Institute's September 5, 2012 "Hedge Funds 2012" event. Breslow is a partner in the New York office of Schulte Roth & Zabel LLP, co-head of Schulte's Investment Management Group and a member of the firm's Executive Committee. Breslow's session focused on, among other topics: developments in fund liquidity terms since the 2008 financial crisis; tools available to a fund manager for managing liquidity risk, including the right to suspend redemptions, fund-level gates, investor-level gates, side pockets and in-kind distribution of assets; duties owed by a fund manager in the context of a liquidity crisis; the evolution in fund manager attitudes towards secondary market transactions in fund interests and shares; and why fund investors have not pushed for the right to remove fund managers in fund governing documents during liquidity crises. This article summarizes key points from Breslow's session.

Changes Impacting Fund Liquidity Resulting from the Financial Crisis

The 2008 financial crisis led to a serious liquidity crunch for many funds. For starters, many funds received significant redemption requests from investors and few new subscriptions. Investors submitted redemption requests for various reasons. In some cases, a fund's performance

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began to slide, and investors' confidence in the fund manager eroded. In other situations, solid-performing funds became piggybanks from which investors, such as fund-of-funds, could withdraw available assets to generate liquidity. Furthermore, funds that obtained leverage via margin or repurchase agreement financing faced liquidity crunches because lenders began demanding more collateral.

In addition, the liquidity crises were compounded by significant hedge fund investments in illiquid assets. In many cases, hedge fund governing documents granted fund managers broad authority to invest in illiquid assets and the authority to house such investments in side pockets. These side pockets looked like mini private equity funds within the main funds, but without many of the key investor protections that private equity fund investors would typically demand (e.g., the ability to remove the fund manager, position limits, clawbacks, etc.).

As a result, many fund managers were compelled, for the first time, to utilize the liquidity management tools that they had included in their fund governing documents.

Liquidity Management Tools Available to a Fund Manager

Suspension of Redemptions

Typically, suspension rights provide the fund manager with the authority to suspend redemptions for as long as, in the fund manager's determination, the criteria for suspension are satisfied. Originally, a fund manager could only suspend redemptions if catastrophic events occurred, causing markets to cease functioning properly. However, prior to the financial crisis, fund managers were able to use their significant negotiating power to expand the set of circumstances under which they could exercise their suspension authority.

Prior to the financial crisis, fund managers rarely suspended redemptions because exercising this right was considered fatal to future capital raising efforts. However, the financial crisis led to many more fund managers exercising their suspension rights. Because suspensions of redemptions proliferated, the option was no longer seen as such a draconian measure. In fact, many well-established managers that suspended redemptions have subsequently lifted such suspensions and have been able to attract new capital.

Nonetheless, a fund manager determined to suspend redemptions will need to carefully weigh the interests of redeeming investors and non-redeeming investors. For instance, in the case of a distressed debt-focused manager that has retained dry powder to make investments when opportunities present themselves during economic crises, significant redemption requests can thwart the manager's ability to make such opportunistic investments, to the detriment of the fund's committed investors. See "Why Do Hedge Funds Have So Much Dry Powder, and What Are They Doing to Keep It Safe?," The Hedge Fund Law Report, Vol. 2, No. 20 (May 20, 2009). In determining whether to suspend redemptions, the interests of such committed investors should be strongly considered by the fund manager. However, the interests of investors wanting to redeem should also be considered because of the fund manager's fiduciary obligations and the desire to avoid generating any ill will with such investors.

Investors who are opposed to the suspension of redemptions are often concerned about the possibility that a fund manager will abuse its suspension authority by locking up investors and continuing to collect fees on investments that it ceases to actively manage. Funds that a manager is no longer actively

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managing from which the manager continues to collect fees have come to be known as "Zombie Funds," and a trend of litigation has commenced – especially in the Cayman Islands – based on a theory of "loss of substratum," meaning that the fund is no longer serving its purpose. See "Cayman Islands Grand Court Rules That Hedge Fund Investor Is Entitled to Court-Supervised Liquidation of Fund, Even Though Fund Managers Were Conducting 'Ad Hoc' Liquidation With the Support of a Majority of Fund Investors," The Hedge Fund Law Report, Vol. 4, No. 2 (Jan. 14, 2011).

Gates

A gate is a liquidity management tool that allows a fund manager to limit the amount that an investor is permitted to invest during any given redemption period. Before the financial crisis, most fund managers maintained fund-level gates, which typically provided that if the aggregate redemption requests received by the fund for any given redemption period exceeded a designated percentage of all of the fund's assets (often 20-25%), each investor's redemption request would be scaled back pro rata based on the total amount permitted to be redeemed from the fund for that given redemption period. See "What Are Hybrid Gates, and Should You Consider Them When Launching Your Next Hedge Fund?," The Hedge Fund Law Report, Vol. 4, No. 6 (Feb. 18, 2011). To prevent investors from being locked up indefinitely, fund sponsors would often agree to a "clean up call," which would provide that in no event would a fund-level gate inhibit an investor's ability to fully cash out beyond a designated period (typically, beyond four quarters for funds permitting quarterly redemptions).

However, the functioning of fund-level gates diminished the manager's ability to predict the amount to be redeemed for any given redemption period. This is because redemption requests could be revocable in whole or in part. While redemption requests are required to be received by a certain date, investors were typically permitted to rescind their redemption requests before their interests were actually redeemed. To avoid the risk of the fund manager imposing the gate, investors began submitting redemption requests as early as possible and for the full amount of their investments, not because they actually intended to redeem such investments in full, but rather, in order to preserve the option to redeem as much of their investments as possible in the event that the fund manager decided to impose the gate. In the days leading up to the date by which a fund manager would have to declare whether it would be imposing the gate, investors began to inquire regularly about the quantity in redemption requests received to evaluate their decision on whether to revoke the redemption request, in whole or in part. From the manager perspective, uncertainty regarding whether investors would stick with their redemption requests or revoke them made it difficult to manage liquidity around redemption dates. To avoid breach of fiduciary duty claims, many managers decided to disclose to all investors the amount in redemption requests that had been received for a given redemption period. However, such notifications often triggered additional redemption requests, thus exacerbating liquidity problems, creating negative chatter or publicity and inhibiting capital raising. See "How Can Hedge Fund Managers Prevent or Mitigate Revocations of Redemption Requests?," The Hedge Fund Law Report, Vol. 2, No. 21 (May 27, 2009).

To avoid the "run-on-the-fund" problem described above, fund managers began to implement investor-level gates in addition to, or in place of, fund-level gates. An investor-level

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gate limits the amount of an investor's redemption request for any given redemption period based on a designated percentage (usually 20-25%) of the total capital the investor has invested in a given fund or share class. Investor-level gates allow a fund manager to better predict fund liquidity for a given redemption period, and help mitigate the other problems associated with runs on fund, as described above. See "Soft Lock-Ups Help Hedge Fund Managers Reconcile the Goals of Stable Capital and Investor Liquidity," The Hedge Fund Law Report, Vol. 3, No. 45 (Nov. 19, 2010).

Side Pockets

As mentioned above, side pockets are separate sleeves in a fund portfolio where less liquid investments are typically segregated and held until a realization or deemed realization event occurs. Redeeming investors typically do not have the right to redeem amounts invested in side pockets until the investment is realized. New investors do not participate in investments in side pockets that existed at the time of their subscriptions. Fund general partners typically only earn carry on side pocketed investments once disposition of the assets occurs.

While side pockets were originally intended for holding investments that are illiquid when the investment was originally made, many fund managers began to put into side pockets investments that were previously liquid when acquired, but subsequently became less liquid. This practice creates the potential for abuse. For example, if an investment incurs a loss, a manager might be tempted to move such investment into a side pocket to avoid including such losses in calculating the fund's net asset value (NAV) and calculating the fund manager's performance compensation. Where there is a legitimate case for putting an investment that is underwater in a side pocket, some but not all fund managers will net the losses from such investments against NAV in the liquid pool for purposes of calculating performance compensation – even though the fund documents do not require such netting. In the period following the financial crisis, where negotiating power has shifted towards fund investors, most fund governing documents either do not permit the fund to create side pockets or only allow the fund to create side pockets if the fund investors have the right to opt out of side pocketed investments. Breslow indicated that, in her experience, investors almost never opt into participation in side pocketed investments when given the choice of whether to do so. See "Six Important Lessons for Hedge Fund Managers, Investors, Administrators and Others in Structuring Side Pockets and Monitoring Their Use," The Hedge Fund Law Report, Vol. 4, No. 8 (Mar. 4, 2011).

In-Kind Distributions

Fund managers also typically include in fund governing documents the authority to distribute assets in-kind to fund investors to facilitate the disposition of hard-to-dispose-of assets, should this become necessary or advisable in the view of the manager. Breslow described in-kind distributions as "synthetic side pockets." Fund investors can either receive distributions of fund assets directly in-kind from the fund or through distributions of interests or shares in special purpose vehicles (SPVs), which house such assets until they are liquidated. Some fund managers will create liquidating SPVs where hard-to-dispose-of assets are transferred to an SPV, and the interests or shares in that SPV are distributed to investors as part of the redemption proceeds from their redemption requests. A liquidating SPV should be established as a legal entity that does not require an investor's consent to become an interest holder (such as a limited partnership) or that would give rise to an additional layer of taxation

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(such as a Delaware corporation). With respect to domestic funds, liquidating SPVs are typically organized as Delaware trusts. In the case of offshore funds organized in the Cayman Islands, liquidating SPVs are typically organized as exempted companies. See "Hedge Fund Managers Using Special Purpose Vehicles to Minimize Adverse Effects of Redemptions on Long-Term Investors," The Hedge Fund Law Report, Vol. 2, No. 15 (Apr. 16, 2009).

The SPV should be capitalized with sufficient cash to handle follow-on investment needs. If it does not have sufficient cash to make follow-on investments, a fund manager should consider the conflicting interests of investors in the main fund (including post-crisis investors who subscribed for new classes of interests offered by the sponsor that carved out problematic assets from the legacy fund) in determining whether it should fund such follow-on investments with the assets of the main fund. See, e.g., "Steel Partners' Restructuring and Redemption Plan: Precedent or Anomaly?," The Hedge Fund Law Report, Vol. 2, No. 34 (Aug. 27, 2009).

Another question that arises in connection with in-kind distributions is whether fund managers should be charging management fees on assets held in such liquidating SPVs. On one hand, the fund manager can continue to manage the investments (and collect management fees) and exercises its fiduciary duties for the benefit of investors as opposed to selling such assets at fire-sale prices. On the other hand, an investor exercising redemption rights has indicated that it no longer wishes to pay management fees on the amount sought to be redeemed. So, the investor should not be required to continue paying management fees on amounts it wishes to redeem. In general, fund managers do not charge fees on assets in liquidating SPVs. See "Secondary Market Develops in Special Purpose Vehicle Interests as Use of SPVs to Effect Redemptions Becomes More Common," The Hedge Fund Law Report, Vol. 2, No. 16 (Apr. 23, 2009).

Dissolution

In the face of a severe liquidity crisis, instead of invoking the various liquidity management tools described above, a fund manager may determine to dissolve the fund and liquidate its assets. This process usually involves informing investors that the fund manager will not process redemption requests as per the fund documents, but rather, will liquidate the assets and cash out investors in an orderly fashion over a reasonable period. Fund managers sometimes provide for breaks on management fees during the liquidation process. See "When Can the Liquidators of Non-U.S. Hedge Funds Access U.S. Bankruptcy Courts to Obtain Ancillary Relief for Fund Investors?," The Hedge Fund Law Report, Vol. 4, No. 32 (Sep. 16, 2011).

Renegotiation with Investors

Breslow pointed out that liquidity management tools may not only be useful in themselves, but also for negotiating leverage. That is, fund managers that are armed with the authority to suspend redemptions or to sell assets at fire-sale prices may have some bargaining power, in certain circumstances, to negotiate with investors to add other liquidity management mechanisms into the fund governing documents where such tools did not previously exist. For instance, a fund manager may propose that investors consent to the addition of a fund gate or the authority of the fund manager to side pocket illiquid investments where these tools were not originally included in the fund governing documents. In return, the fund manager would agree to avoid invoking more drastic liquidity management measures, such as the suspension of redemptions.

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For more information on liquidity management tools, see "Structuring, Valuation, Fee Calculation and Other Legal and Accounting Considerations in Connection with Hedge Fund General Redemption Provisions, Lock-Up Periods, Side Pockets, Gates, Redemption Suspensions and Special Purpose Vehicles," The Hedge Fund Law Report, Vol. 3, No. 43 (Nov. 5, 2010).

Fiduciary Duties

Pursuant to Section 206 of the Investment Advisers Act of 1940 and Rule 206(4)-8 thereunder, fund managers must affirmatively keep investors informed of material events impacting their investments on an ongoing basis. Therefore, fund managers now have to think more actively about making disclosures concerning material issues affecting the portfolio, including liquidity issues, mark-downs, defaults on a fund's credit facility and calls on a fund's margin facility.

The new anti-fraud rule, coupled with the increased sophistication of investors (especially fund of fund investors) concerning liquidity issues, has resulted in significantly more transparency being provided by fund managers concerning liquidity than there had been in the past. Fund managers must be deliberate about how they communicate regarding liquidity issues to investors; managers are increasingly looking to both lawyers and public relations firms to assist in this effort.

Breslow explained that, in general, fund managers perceived to be hiding mistakes or delaying disclosure are less likely to retain investor trust and capital than fund managers that are more forthright about material issues, including any liquidity problems faced by their funds. See "What Do Hedge Fund Investors Want in Terms of Liquidity and Transparency?," The Hedge Fund Law Report, Vol. 4, No. 39 (Nov. 3, 2011).

Secondary Market Transactions in Fund Interests and Shares

Fund managers' attitudes towards secondary market transactions in their fund shares have evolved from active resistance to modest acceptance. Prior to the financial crisis, many fund managers disapproved of secondary market transactions in fund shares. Around the original launch of Hedgebay – a secondary market trading platform for the purchase and sale of hedge fund interests and shares – many fund managers thought that the posting of interests in their hedge funds for sale on Hedgebay sent the message to other investors that the fund could be experiencing distress. Fund managers became more sensitive about having their funds appear on the "sell-side" page due to the perceived reputational damage that such an association was thought to cause. Fund managers became adamantly opposed to such trading platforms and communicated to their investors a policy that they would, in all cases, exercise their authority to withhold consent to any secondary transfers of fund interests or shares brokered on Hedgebay or similar websites. See "Valuation and Confidentiality Concerns in Secondary Market Trading of Hedge Fund Interests," The Hedge Fund Law Report, Vol. 1, No. 27 (Dec. 9, 2008).

As an alternative to platforms such as Hedgebay, fund managers sometimes tried on their own to match buyers and sellers of interests in their funds. However, Breslow cautioned that the introduction by a fund manager of too many selling investors to a buyer could implicate SEC tender offer rules requiring disclosure and publicity. Such disclosure could have adverse regulatory and public relations repercussions, which could exacerbate the selling trend and cause other problems.

The financial crisis, however, occasioned a change in perspective with respect to secondary trading in fund

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interests. Managers warmed to the idea, in general. Many fund investors were locked-up in funds where redemptions had been suspended. To avoid having to deal with disgruntled investors, many fund managers became more open to allowing such investors to sell their fund interests or shares to other investors on the secondary market. For more on managers' current views with respect to secondary trading in fund shares, see "Sixth Annual Hedge Fund General Counsel Summit Highlights SEC Enforcement Priorities, Side Letters, Investment Allocations, Expense Allocations, Trade Errors, Record Retention, Fund Marketing, Secondaries, JOBS Act and STOCK Act (Part One of Two)," The Hedge Fund Law Report, Vol. 5, No. 39 (Oct. 11, 2012).

Removal of Fund Manager

Some industry participants expected the financial crisis to result in more demands from investors for the right to remove a fund manager in designated circumstances. However, this trend has not materialized. In contrast to private equity fund investors, hedge fund investors have not, in the majority of cases, pushed for the contractual right to remove the fund manager. Investors tend not to push for this right principally because they believe that the nature of the fund's assets are such that there would be a significant learning curve for a new manager to get up to speed to effectively manage the portfolio. Unless the remaining assets are very significant, it is not generally perceived as a worthwhile course of action to follow, even if the fund manager is doing a particularly poor job at managing the assets. Nonetheless, investors sometimes seek the removal right where the investors believe that: (1) the fund manager could sell the assets, but is avoiding doing so because it wants to sit on them and continue collecting fees; (2) the fund manager is recklessly creating new losses as opposed to minimizing old ones; (3) circumstances are such that a replacement fund manager can step in and do a significantly better job managing the portfolio and generating liquidity, and the remaining assets under management justify taking this action; or (4) it could use the threat of an action to remove the fund manager in order to achieve a concession on fees.

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