Schulte Roth & Zabel

Private Funds Guidance —

Considerations During Volatile Markets for Hedge Funds and Credit, Direct Lending and Distressed Funds (COVID-19)

March 16, 2020

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As COVID-19, oil price movements and other geopolitical factors continue to roil the financial markets, there are steps that all investment managers can and should take to mitigate legal risks for themselves and their investors. In addition, there are specific challenges and opportunities for managers of hedge funds and credit, direct lending and distressed funds. In this note, we highlight some of the most relevant considerations.

Please see our other Schulte Roth & Zabel *Alerts* relevant to Investment Managers posted on our COVID-19 Resource Center, available here. See our *Alert* for tax issues raised or exacerbated by current market conditions and buying opportunities, available here, our *Alert* on cybersecurity, available here, our various *Alerts* on regulatory updates and our *Alert* on Considerations for Private Equity Fund Sponsors, available here.

I. Immediate Considerations for All Investment Managers

A. Operations

1. Confirm that business continuity plans ("BCPs") are fully operational.

2. Seek to understand vendors' BCPs and how the implementation of vendor BCPs may affect the investment manager and its funds. Examples of critical vendors include:

(a) Banks

(b) Custodians

(c) Fund administrators

(d) Executing and prime brokers

(e) Futures commission merchants

(f) Outsourced traders

(g) Third-party hardware, software and systems and support providers

(h) Cybersecurity consultants

3. Try to identify in advance any operational disruptions that may occur at month-end. For example, hedge fund managers should review their ability to strike a net asset value ("NAV") on time, and their ability to value Level 2 and Level 3 assets in a timely manner.

4. Consider the effect of any potential business and government office closings and unscheduled public holidays on payments, deliveries, notices and other operations.

B. Investor Relations

1. Investors expect regular communication. Investment managers should be prepared, be organized and communicate clearly, particularly if they may have liquidity issues or other potentially adverse events to manage.

2. Ensure that information is provided consistently and not selectively to investors.

3. In stressful situations, investors' trust will be put to the test, and investors may have their own liquidity and other needs to prioritize. In our experience during and since the Global Financial Crisis, regular and clear communication with investors goes a long way towards maintaining trust and good relations, while poor communication can erode goodwill and compound a difficult situation.

4. Regulators also expect to see good communication, and disclosure where required, between investment managers and investors.

C. Offering Materials

1. Investment managers should evaluate with counsel whether they need to supplement their offering materials (e.g., with a PPM Supplement) for funds open for fundraising and for hedge funds with investor redemption rights.

2. Any such materials need to comply with Rule 10b-5, which prohibits material misstatements or the omission of any "material fact" necessary to avoid a misleading statement.

3. Risk Factors will likely need to be updated to address the general risks presented by the COVID-19 pandemic as well as any specific risks to which a fund is exposed (e.g., operational or valuation challenges, investments in travel, hospitality, sports or entertainment companies or properties).

4. Keep in mind whether a disclosure is sufficient may be judged in hindsight, according to the view of a reasonable investor. It is advisable to be inclusive and thorough, especially when circumstances are changing quickly.

D. Performance Presentations

1. Consider whether track record presentations and other performance-related materials may require modification or enhancement. For example, if the assets held in a prior fund or a fund being currently marketed have been particularly volatile or hard hit, discuss with counsel whether that is material information that should be disclosed and explained.

2. Likewise, if a fund's portfolio holdings change materially, or if valuation issues arise, discuss with counsel whether those developments are material and should be disclosed and explained.

3. Investment managers should assume that their marketing materials and track record presentations will, as with other aspects of their responses to current COVID-19 and market developments, be scrutinized by investors and regulators.

II. Considerations for Hedge Funds and Other Open-End Funds

A. Trading Agreements and Other Financing Arrangements

1. Hedge fund managers should review their funds' trading agreements, including ISDA master agreements and prime brokerage agreements, to evaluate NAV triggers and margin call obligations. Issues to think about include —

(a) NAV triggers typically include monthly, quarterly and annual performance triggers, as well as an overall floor trigger, but provisions differ in the details. For example, some provisions are solely performance-based, while others also take into account net redemptions.

(b) Prime brokerage agreements typically allow the prime broker to adjust financing costs at its discretion.

(c) In the case of funds that have margin term lock-ups, such agreements typically contain termination provisions related to the fund's performance as well as the credit of the dealer. It is important to understand the circumstances under which a lock-up will terminate.

(d) The 2002 pre-printed ISDA master agreement and many negotiated Schedules to the 1992 ISDA master agreement contain force majeure clauses.

2. Consider being proactive in reaching out to counterparties in advance of tripping termination events or other events of default.

3. Current market conditions may lead to margin calls in fund financing agreements. Investment managers should evaluate the liquidity of their assets in stressed market conditions in connection with monitoring their ability to meet potential margin calls.

B. Subscriptions

1. Continued market volatility will put a greater focus on valuations in general, in particular on "dealing days" when subscriptions are taken and redemption prices are determined.

2. Allowing late subscriptions without restriking the NAV is inadvisable.

3. Striking an intra-month NAV is permissible under most hedge fund governing documents (although doing so can be a significant undertaking, and fund administrators may be unable or unwilling to strike an intra-month NAV).

C. Valuations

1. For most investment managers, valuation processes for Level 1, Level 2 and Level 3 assets are already robust. However, market volatility, especially if it continues through a month-end, will draw attention and scrutiny from subscribing and redeeming investors, and eventually fund auditors and regulators.

2. For funds that have a material amount of assets categorized as Level 2 and/or Level 3, the inputs should be carefully considered for depth and appropriateness.

(a) For example, broker quotes may have greater than normal divergence.

(i) Gathering additional quotes may be prudent.

(ii) It is also important for fund managers to be comfortable with the sources of broker quotes and what those quotes represent (e.g. indicative values, based on active trading, etc.).

(iii) Analyzing broker quotes for stale prices and other relevant factors is an important part of the process.

(iv) Understanding how familiar the quoting brokers are with the subject investment is very important (e.g. market maker, underwriter, etc.).

(b) Information obtained subsequent to a balance sheet date related to illiquid positions should be assessed, and whether such information would have or should have an impact on initial estimates of fair value should be considered. This is especially important in times of evolving market conditions.

(c) Model-based valuations may present especially challenging issues —

(i) How often are models updated?

(ii) Do models factor in current market conditions?

(iii) To what extent should models factor in extreme market movements in a short timeframe?

(iv) Are underlying inputs and assumptions reasonable and appropriate in the current market environment?

3. Be aware that assets which have reduced liquidity will present valuation challenges and may drop to Level 2 or Level 3, thereby requiring a different valuation methodology.

(a) A failure to adjust a valuation methodology or reassess critical inputs to a valuation model when facts and circumstances evolve may be an issue in the annual audit and raise a question later about whether NAV should be restated.

(b) A failure to adopt a different methodology at the relevant time may be an issue in the annual audit and raise a question later about whether NAV should be restated.

(c) A NAV restatement presents significant reputational risk and may not be able to be fully remediated (i.e., clawing back redemption proceeds from investors may be the theoretical remedy but legally or practically unavailable).

4. Consider if third-party valuation firms will be able to provide valuations in the normal timeframe for striking a NAV, and if fund administrators will be able to process NAV determinations on a timely basis.

(a) Modest delays (from a few days up to the end of the next month) should not be problematic if the reason is to ensure that valuations have integrity given market conditions.

(b) In extreme cases, it may be necessary to suspend the determination of NAV.

5. To avoid surprises at audit time, it may be wise to consult with the fund auditors regarding the valuation process and inputs in these market conditions.

6. Since valuations in the context of NAV-based management fees and mark-to-market incentive compensation present a conflict of interest, these matters should be approached thoughtfully and with the advice of counsel.

D. Redemptions and Liquidity Management Options

1. Redemption Concerns. Evaluate whether current and any projected redemption requests can be met in the timeframe required under the fund documents.

(a) In the Global Financial Crisis, many assets which had traded in liquid or reasonably liquid markets became substantially illiquid.

(b) The substantial uncertainty about the ultimate extent and duration of the COVID-19 pandemic makes predicting liquidity difficult. Investment managers should nevertheless think ahead about liquidity — the fund's need for cash to pay expenses, meet margin requirements and pay redemption proceeds — not only in the first and second fiscal quarters of 2020 but also several quarters ahead.

(c) An important consideration is whether raising cash to meet current redemption requests will result in an unacceptable concentration of illiquid investments for non-redeeming investors.

2. Liquidity Management Options. If liquidity problems are foreseeable, hedge fund managers should assess their options.

(a) Side Pockets.

(i) Most hedge funds do not have the ability to "side pocket" investments (this feature was broadly eliminated after the Global Financial Crisis), but many funds have investor-level gates which limit outflows in any quarter (e.g., often to no more than 25% of NAV).

(ii) For hedge funds with side pockets, they are designed for illiquid and hard to value investments.

(iii) Not all side pocket provisions are the same, and some may not provide a complete solution.

(iv) Some side pockets may be utilized only when an investment is made (i.e., they are not available for existing investments that become illiquid).

(v) Funds that have adopted an opt in/opt out side pocket structure face additional complexities, including how to treat the portion of illiquid assets in which opt-out investors participate when illiquid assets in which opt-in investors participate are being moved to side pockets, and how to fairly account for the possibility that the fund's liquid assets may be depleted by margin calls and expenses. Similar issues arise when considering how to fund rescue follow-on investments held in side pockets for a subset of investors, some of whom have otherwise redeemed. Counsel can advise on several approaches to these situations.

(b) Fund-Level Gates.

(i) Fund-level gates (if permitted in a fund's governing documents) can be applied to limit the overall redemption amount on each redemption date.

(ii) Using a fund-level gate is an extraordinary measure, and an investment manager should consider how many quarters the gate may be needed and if in fact using the gate will be enough to address the fund's liquidity concerns.

(iii) Investors will want to know the specific reasons for using the gate and how long the gate will likely be in effect.

(c) Suspension of Redemptions and NAV.

(i) All hedge funds have the ability to suspend redemption requests and/or the payment of redemption proceeds in certain circumstances (which must be done prior to a redemption date), but a relevant basis for suspending redemptions must be found in the fund's governing documents.

(ii) Broadly worded suspension provisions permit suspensions based on market conditions or potential harm to investors.

(iii) Narrowly worded suspension provisions may permit suspensions only as a result of objective extraordinary events such as market closures or a breakdown in communications.

(iv) Suspending redemptions and/or the payment of redemption proceeds are an extraordinary measures and their use should be considered carefully.

(v) Investors will want to know the basis for suspending, how long the suspension will likely be in effect and whether it is likely be temporary or permanent, leading to fund liquidation.

(d) Distributions of Assets In-Kind.

(i) Most hedge funds have the authority to distribute assets in kind (e.g., illiquid assets) as a way to satisfy redemptions. This can avoid increasing the concentration of illiquid assets and depleting cash in the fund to the detriment of non-redeeming investors.

(ii) Investor side letters should be reviewed. A common side letter provision precludes the distribution of assets in kind to the investor with the side letter, or provides that the investment manager will sell the investment on the investor's behalf.

(e) Creation of SPVs and Distribution of SPV Shares In-Kind.

(i) Since the Global Financial Crisis, we have built into most of our hedge fund documents the ability to create SPVs (which must be done prior to the redemption date) to which illiquid assets can be transferred and distribute SPV shares in kind to redeeming investors.

(ii) Like distributions in-kind discussed above, using an SPV prevents increasing the concentration of illiquid assets in the fund to the detriment of non-redeeming investors.

(iii) Using an SPV also enables the investment manager to sell or manage the investments on behalf of the redeeming investors, which is often desired by investors because many of them have no expertise, ability or desire to hire another investment manager to sell or manage the illiquid assets themselves.

(iv) The ability to charge fees for managing an SPV should be analyzed.

(v) The SPV is also helpful if assets cannot be easily transferred to investors as part of a distribution in-kind due to legal or contractual transfer restrictions.

(f) <u>Fund Run-Off and Liquidation</u>.

(i) Funds facing very substantial redemption requests or a portfolio that has sustained significant losses may no longer be viable, and a decision may be made to close the fund.

(ii) A fund liquidation may be handled by suspending redemptions and liquidating the portfolio and distributing the proceeds, or by putting the fund into formal liquidation. The choice will depend on the circumstances.

(iii) These options “level the playing field” by cancelling redemption rights and enabling pro rata distributions to all investors.

(iv) Fund liquidations are often coupled with offering investors to "roll" their investments into a new fund (discussed below) which has longer liquidity terms rather than liquidate and lock in losses or prematurely end an investment strategy or thesis.

(g) <u>Offering New Liquidity Options to Investors</u>.

(i) Investment managers may offer investors new liquidity options that require investor consent to implement. For example, investors may be asked to lock up their investments for a period of time in exchange for lower fees, or to move their investment in the fund (via a distribution and contribution of their share of the fund’s portfolio) to a closed-end or slow pay hybrid fund, or a fund of one or managed account, managed by the investment manager that is better aligned to the portfolio’s liquidity.

(ii) Investor elections are being used and/or actively considered by numerous investment managers.

(iii) This option is often attractive to investors who have longer time horizons, want to take advantage of being the patient money, and/or want to avoid being the “last investor” in a fund with a high concentration of illiquid assets or being too exposed to continuing redemption pressures.

III. Considerations for Credit, Direct Lending and Distressed Funds

A. Withdrawal Pressures

1. Credit, Direct Lending and Distressed Funds utilize a variety of liquidity terms.

(a) About 2/3 of these funds use closed-end structures, resembling private equity funds in that they do not offer withdrawal rights to investors.

(i) Absent any special liquidity terms, these funds should be immune from liquidity pressure coming from investors. However, investors may exercise no-fault rights to end the investment period, force dissolution of the fund and/or replace the general partner(if fund documents allow this action).

(ii) Funds at or approaching the end of their terms may face liquidity pressure if assets cannot be sold or otherwise disposed of. In that case, a distribution in-kind mechanism, an extension of the fund's term, special liquidity options or a GP-led secondary transaction could be considered to address investors' needs for liquidity.

(b) About 1/3 of these funds use open-end (hedge fund) structures or hybrid structures.

(i) Those funds which are open-ended may need to rely on the various liquidity management options discussed above.

(ii) Those funds which use hybrid structures usually have a "slow pay" withdrawal feature (i.e., an internal liquidating account, which enables the fund to pay withdrawal proceeds to a withdrawing investor over time when assets are sold). This is in contrast to typical hedge fund redemption rights, which require the fund to generate cash to pay a set redemption amount that crystallizes on a date certain (month-end or quarter-end) and must be paid to the investor in cash within a set timeframe (typically 30 to 45 days).

(iii) The slow-pay feature should protect hybrid funds from being forced to sell assets at inopportune times and suboptimal prices.

2. In addition, some investors may seek liquidity on their own terms and arrange transfers of their fund shares, LP interests and/or SPV interests in the secondary market.

B. Valuations

1. Most Credit, Direct Lending and Distressed Funds hold a substantial amount of Level 2 and Level 3 assets.

(a) Many such funds charge management fees based on monthly or quarterly NAV.

(b) Most closed-end funds and some hybrid structures receive carried interest or other types of incentive distributions based only on realizations.

(c) However, some such funds factor in unrealized losses and others charge incentive allocations based on realized and unrealized gains and losses. These latter types of funds may be significantly affected by valuation concerns during volatile market movements and should focus on the concerns outlined above under "Valuations."

(d) Since valuations in the context of investment manager and general partner compensation present a conflict of interest, these matters should be approached thoughtfully and with the advice of counsel.

C. Capital Call Defaults

1. Market conditions may lead to investors defaulting on capital calls. The general partner must decide what action to take against the defaulting investor, if any.

(a) Not taking action against defaulting investors can lead to complaints from other investors.

(b) Another concern is that disclosing a default will cause others to follow suit and not fund.

(c) A general partner does not necessarily have to exercise the same remedy against each defaulting investor, but there need to be reasons why the choice of remedy or to forego a remedy is in the best interest of other investors in the fund (and not, for example, driven by the general partner's outside relationship with the defaulting investor).

D. Subscription Lines

1. Many Credit and Direct Lending funds have relied heavily in recent years on subscription lines and other forms of leverage to fund their investments. Now is the time to revisit those credit agreements and consider whether those sources of liquidity will be stable. In particular, note the following:

(a) Credit agreements often have a condition precedent to borrowing based on the absence of any event that could have a material adverse effect on the business, operations, condition (financial or otherwise), liabilities (including contingent liabilities), business or assets of the borrower or other applicable loan parties (an "MAE Event"), or a representation as to the absence of such an MAE Event that must be brought down at the time of borrowing. Some credit agreements may even have an event of default based on the occurrence of an MAE Event. While lenders should generally be wary of relying on such a general condition, representation or default to block funding or exercise remedies, the unprecedented and global nature of the COVID-19 pandemic should lead credit funds to consider accessing credit lines at this time.

(b) Subscription facilities in particular extend credit based on unfunded capital commitments of the fund's investors or a subset of "included investors" and the lender's analysis of the creditworthiness of such investors. Such investors may be excluded from the borrowing base on the basis of a rating downgrade, material decline in net worth or even an MAE Event affecting such investor. Any such trigger could reduce borrowing availability under a subscription facility and require a prepayment. Therefore, funds should keep track of their investors for any signs of credit deterioration.

(c) Subscription facilities may also have financial covenants based on the fund's NAV, including loan to value covenants, that should be examined and monitored.

E. Other Forms of Leverage, including Asset-Based and Structured Facilities

1. Other forms of leverage utilized by funds, including asset-based and structured facilities, should be reviewed.

(a) noted above, most credit facilities include the absence of an MAE Event as a condition to borrowing.

(b) Asset-based facilities may have market-value tests which will assess the current market value of the pool of collateral and may require a prepayment if the market value decreases.

(c) Asset-based facilities which do not utilize market-value tests may still revert to a market value measure once particular assets default or suffer credit down-grades.

(d) Collateralized loan obligation issuances ("CLOs") may have some of the above features. CLOs often impose trading restrictions if the CLO securities are downgraded. CLOs may divert interest proceeds (that would otherwise be distributed to equity holders) to pay down the CLO liabilities if coverage tests are not met.

(e) CLOs usually carry their collateral obligations (other than collateral obligations purchased at a discount) at par value for purposes of overcollateralization tests. However, defaulted collateral obligations are typically counted at market value for overcollateralization tests, and collateral obligations whose ratings are "CCC+" or below (to the extent not treated as defaulted obligations) are also typically adjusted for purposes of the overcollateralization tests.

(f) For CLOs purchasing collateral obligations at discounted prices (below certain threshold prices, depending on the ratings of the obligations), it is important to recall that these collateral obligations will be carried at their purchase price for purposes of the overcollateralization tests.

(g) Engagement letters for CLOs usually have no-MAE Event conditions that are broadly written and expressly include the absence of adverse market conditions, which if not satisfied in the discretion of the CLO arranger, would entitle the arranger to determine not to proceed with CLO.

(h) Arrangers and other banks that provide warehouse credit facilities (whether in anticipation of a CLO or as permanent financing) will usually retain full discretion to approve assets to be acquired under the warehouse facility. During adverse market conditions, the bank could use this discretion to cease approving assets, in effect cutting off further funding.

IV. Other Items for All Investment Managers to Consider

A. Reporting

1. The alternative investment fund industry generally operates at a high standard for reporting detail and risk, if not position transparency.

2. Standards should be maintained as much as possible even though working conditions under the COVID-19 pandemic may present challenges.

B. Offshore Independent Directors, LPACs, Special Advisory Committees, Investor Consent

1. Under a fund's governing documents, certain actions may require consent from independent directors (e.g., instituting a gate, suspending redemptions, liquidating) or LP Advisory Committees (e.g., changing investment limitations, extending investment periods, approving cross-trades and conflicts of interest).

2. Even when such approvals are not necessarily required, seeking approval can be an excellent risk mitigator for a general partner or investment manager where a transaction or interpretation of the fund documents presents risk to the general partner or investment manager.

3. Many of our fund partnership agreements make provision for the general partner to create ad hoc special Advisory Committees. The members can be investors, offshore directors and/or other qualified independent persons, as determined by the general partner. These Advisory Committees are empowered under the partnership agreement to review and approve on behalf of all investors conflicts of interest and other matters affecting the fund.

4. Investor consent, while often cumbersome, can also be used to mitigate risk. It is most often sought when amendments to the fund governing agreements are needed (e.g., to change investment restrictions or permitted strategies, change liquidity terms or create side pockets) and investor approval is required under the governing agreements.

5. Independent directors, LP Advisory Committees and special Advisory Committees can also serve as important sounding boards for a general partner or investment manager trying to decide what direction to take on an issue or opportunity.

C. Public Relations Help — Managing the Public Message

1. Having a good public relations firm on retainer and involved in any potentially press-worthy actions is highly advisable.

2. Actions such as delaying or suspending redemptions or holding a high-profile investment that itself suffered losses or poor performance may land an investment manager in the news instantaneously. The news cycle is quick and every story is copycatted in multiple publications.

3. A good public relations firm can better inform the press and try to avoid inaccuracies and soften sensational reporting.

D. Changing or Expanding Investment Strategy(ies)

1. Taking advantage of new and compelling investment opportunities that present themselves in a volatile market and turbulent times is tempting. Pursuing new investment strategies that the fund has not previously pursued may also be tempting.

2. However, before doing so the investment manager must evaluate whether the fund's disclosure documents and governing documents permit any such new investments (or if approval from independent directors, the LP Advisory Committee or special Advisory Committee is needed).

3. As a fiduciary, the investment manager must have the requisite expertise before pursuing a new strategy.

4. Improperly handled, a change in strategy or style drift can be the basis for claims against the general partner or investment manager of, among other things, fraud, breach of contract or violation of the securities laws.

E. Credit Dislocation Opportunities; Overflow Funds; Co-Investment Platforms

1. For investment managers which have a fund that is only supposed to be activated on a credit dislocation, they may now have an opportunity to do so.

2. Investment managers which have set up overflow and co-investment vehicles or platforms may find that those funds provide the quickest path to market.

3. Sometimes if particular assets have become troubled as result of credit dislocation, current market conditions can be an opportunity to raise additional capital or a new fund that does not have exposure to those assets.

This SRZ publication was principally authored by Stephanie R. Breslow, Josh Dambacher, Jennifer M. Dunn, David J. Efron, Christopher Hilditch, Daniel F. Hunter, Peter G. Naismith, David Nissenbaum, Daniel V. Oshinsky and Craig Stein with thoughtful input from many of their colleagues in the SRZ COVID-19 Working Group.

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