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COVID-19: Certain Considerations for Open-Ended Fund Managers; Looking at 3/31, and Beyond

As financial markets continue to exhibit extreme volatility as a result of COVID-19, related macro and geopolitical factors and oil price movements, managers of hedge funds (and other open-ended and evergreen funds) should assess challenges and vulnerabilities to their businesses, as well as potential opportunities that may lie ahead.

Portfolio financing and trading counterparties; rescue financings

Similar to 2008, with mark-to-market valuations taking a significant hit (even when the fundamentals of the underlying investments might not have changed) and lenders increasing lending-based "haircuts," the most immediate challenge many managers face relates to their trading counterparties.

In this regard, managers should consider:

- reviewing their trading agreements to ensure they understand the various triggers and termination provisions their trading counterparties may look to exercise;
- engaging proactively with their trading counterparties to make sure the counterparties understand the portfolio composition, its liquidity and assets' intrinsic value relative to their (presumably temporary) mark-to-market valuations; and
- if liquidity is expected to be an issue, alternative ways to protect the portfolio against defaults and associated remedies (*e.g.*, BWIC by lending counterparties). Certain rescue financing tools utilized in 2008 may be available nowadays, such as equity infusions, debt infusions and convertible debt structures.

Handling redemptions

Redemptions may not be targeted only at funds experiencing poor performance, but also at those with steady or strong returns – with the latter effectively acting as a more stable source of liquidity for investors (a/k/a "being an ATM"). Managers whose funds have longer redemption notice cycles may also be able to foresee significant redemptions down the road, and should consider future liquidity needs sooner rather than later, including when evaluating current redemptions. Compounding the redemption challenge, many funds have invested increasingly in assets that are, or have become, illiquid.

In this context, managers may want to:

- monitor the level of illiquidity in your portfolio, including relative to redemption schedules. Assess whether, in this environment, even if you do not currently face a liquidity issue, it is prudent to reduce illiquidity in the portfolio and/or to draw upon any available mechanisms (such as side pockets) to minimize the possibility of any liquidity mismatch in the near future;
- review your fund documents to assess the alternatives and prepare for any liquidity mismatch – for example, the ability to distribute in kind, establish liquidating trusts or special-purpose vehicles ("SPVs"), use synthetic SPVs, invoke fund-level or investor-level gates, utilize "slow-pay" redemption features and exercise suspension rights. As mentioned in our March 11 alert, each of these tools is typically subject to certain procedural, timing and approval parameters that should be followed in order to implement them in the most efficient and legally protective way;
- prepare and potentially implement a plan for providing investors with an alternative to redemption by, for example, offering to restructure all or a portion of the fund into a new closed-ended structure;
- regardless of the form of liquidity tool(s) implemented, ensure that reserves are sufficient for management fees, expenses and follow-on investments; monitor ERISA participation; and consult and communicate regularly and transparently with independent directors and key service providers such as external counsel, accountants and counterparties; and
- explore innovative capital retention and raise strategies. For example, implement new classes or sub-classes for new or existing investors with lower fees or a combination of lower management fees and higher incentive-based compensation (*e.g.*, "1 & 30" arrangement), or raise additional capital from existing investors for no or little compensation until the fund is back to positive territory ("back to HWM" vehicles), in either case, potentially in consideration for an initial lock-up or other liquidity limitations.

Taking in additional capital

Certain investors view the historic lows as a good buying opportunity and may wish to subscribe to existing funds in order to gain exposure to existing assets at attractive valuations.

In this regard, managers should:

- be methodical and disciplined in valuing their portfolios and documenting steps taken to ensure reliable marks, especially in the face of fund capital movements (*i.e.*, subscriptions, redemptions and movements to or from side pockets); and

- provide accurate disclosure to investors regarding the impact of recent events on their firm and the funds they manage. Particular attention should be given to assets that are expected to be disproportionately impacted by recent events and to portfolios that are expected to face liquidity pressure (including from trading counterparties).

Messaging and IR

Even more so than in good times, clear, honest and transparent communication with clients is key to maintaining a successful GP-LP relationship. Yet, communications may become a source for investor complaints and regulatory criticism.

In this regard, managers should:

- consider enhancing their communications practices and related policies, particularly as to who should be allowed to speak with investors and what information they are allowed to convey. Using talking points and scripts should be helpful in this regard, and managers should consider having at least two people from the firm on the phone for each investor call; and

- pay particular attention to timing of communications as to avoid concerns about selective disclosure that may impact investor actions.

Exercise discipline with internal communications

Humor and sarcasm tend to not read well in hindsight. Managers should consider refreshing their internal communication practices and remind personnel that “if you wouldn’t be proud to read it in the newspaper, it probably should not be written in an internal, or external, communication either.”

Engage with your board; independent fund representative

Tough times force hard choices. Decisions may be scrutinized in retrospect around conflict of interest and prudence issues, especially if these decisions have not yielded favorable results.

Managers should consider:

- engaging with their funds’ boards of directors sooner rather than later, and in particular making sure that the directors understand the fund, its investment strategy, asset composition, liquidity constraints and other relevant factors. Informed directors are more likely to act effectively; and

- forming/appointing independent client committees/representatives, to the extent permitted under the fund documents. Similar to board engagement, the earlier the committee/representative is familiarized with the manager and the fund, the more empowered they will be to act when necessary and the more likely they will be to act nimbly and productively. Trying to recruit, retain and engage committee members or representatives in real time may prove challenging and ineffective.

Consider the litigation perspective

Both investors and regulators have the benefit of hindsight when scrutinizing actions taken under challenging circumstances.

In this regard, managers should be aware that:

- an organized decision-making process, even one that leads to unsuccessful results, provides significant protection. While not every single decision should be documented, it is advisable to document major decisions, and in particular to be able to demonstrate what facts and alternatives were considered and how conflicts were dealt with;

- having consulted with all constituencies who can bring relevant perspectives touching upon the fund's entire ecosystem – its investors, portfolio, employees, counterparties, regulators and the media – may be a powerful tool when decisions are reviewed in retrospect;

- legal counsel, internal or external, should take part in discussions about alternatives. Appropriately, those discussions may then benefit from a privilege protection; and

- as noted in our March 11 alert, in the past regulators have expressed interest in understanding how managers fulfilled their duty during market disruptions. Memorializing these steps in real time may yield fruit later.

Plan for crisis management

Negative news coverage, regulatory inquiries and investor complaints are only some of the challenges that a fund manager may need to wrestle with in difficult times.

In this regard, managers should consider:

- having a "break-the-glass" plan in place that includes the various functions from which advice is to be sought, taking into account the fund's entire ecosystem; and

- engaging competent service providers in advance, including an investor relations/PR firm and outside counsel, to advise on matters that may come up if a crisis were to take place.

Dislocation brings new opportunities

Certain managers may be well-positioned to offer clients opportunities to invest in a dislocated market. These capital raises may take the form of additional classes in existing funds (which may allow managers to take advantage of opportunities more quickly, and may be spun out later into their own funds), standalone hybrid funds or SMAs/funds-of-one. As always, disclosure issues, conflicts and conflict mitigation strategies, investment allocation parameters and issues under existing funds' governing documents (*e.g.*, devotion of time requirements) should be considered.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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