Article

Suspending NAV, Gating and Options for Funds Fearing a Rush of Redemptions in Light of the COVID-19 Pandemic

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COVID-19 is having a widespread impact on markets and the global economy as businesses struggle with the disruption caused. Falling asset values are likely to reduce the overall value of funds. Investors may seek to redeem their investments as they need to fulfill their own financial commitments and/or their confidence in the fund may reduce. This can lead to funds being unable to meet redemption requests in the usual way whilst still maintaining the value of the fund. This article discusses some of the options available to funds facing a run on redemptions.

Background

Hedge funds are collective investment vehicles, pooling money from investors and investing it according to a particular investment strategy or strategies. Most hedge funds are organised as two or three-tier structures (feeder funds and master funds) with the vehicles incorporated primarily in the Cayman Islands or the British Virgin Islands (sometimes with an onshore feeder fund). The investors enter through feeder funds, which channel funds into the master funds.

When the market crashes (as in 2008), or suffers losses, investors may seek to redeem their shares for a variety of reasons including: fulfilling their own financial commitments, cutting their losses, investing elsewhere and changing investment strategy. This can put immense pressure on the fund as it struggles to maintain value when experiencing a run of redemption requests. If investors redeem and are unpaid, as creditors they rank above the other investors, and the fund may face being wound up.

There are a range of options available to funds with their companies incorporated in the Cayman Islands. The first point to note is that the company's articles will set out the basis on which it is permitted to redeem its shares and there are statutory limitations on the process. This article is not an exhaustive guide to every particular process, each company's constitutional documents will have to be reviewed and the statutory rules applied. Urgent legal advice should be sought in all instances in which a fund faces a litany of redemption requests. Here we set out some options that have been commonly used by funds facing a rush of redemption requests.

Limiting or suspending redemptions and gating

One option, often viewed as drastic, for a fund dealing with a high volume of redemption requests, is to suspend calculation of the fund's net asset value (NAV). This effectively suspends redemptions as until the NAV is calculated there is no ability to calculate an amount due to a redeemer. Again the ability to do this depends on the constitutional documents of the fund. Suspending calculation of the NAV has disadvantages. Understandably it is very unpopular with investors. In addition it means that new subscriptions cannot be accepted during this time and the fund may experience damage to its reputation.

A further option is to actually suspend the redemption payments. Another seemingly unpopular scenario (at least insofar as investors are concerned) but when the market crashed in 2008, some funds that had their redemptions suspended and waited for the situation to improve and then had the suspension lifted, managed to survive.

Many funds also have the ability to impose redemption gates. These restrict the amount and/or timing of redemptions. A typical gate restricts the amount that can be redeemed at a particular redemption date to a percentage of either the total shares in issue or the NAV of the fund. Imposing gates can lead to a flurry of redemptions because as soon as a gate is imposed it establishes a priority among investors who have decided to redeem. Gates can encourage investors to redeem through fear of being last in line. The extent to which and how a fund can suspend redemptions or impose gates is set out in the fund's documentation.

If a fund fails to suspend NAV, suspend redemptions or gate, it can be left with redeemed (but unpaid) investors. If redemptions are due and not paid (assuming the fund has not suspended redemptions according to its documentation), investors become creditors of the fund, and can petition for the fund to be wound up.

Restructuring options

Rather than suspending redemptions or imposing gates, funds may seek to restructure their assets to provide alternative solutions for investors wishing to redeem, without destabilising the fund or prejudicing the remaining investors. Side pockets and in specie distributions are popular options.

Side pockets

Side pockets are typically used to differentiate liquid and illiquid assets. Once a side pocket is created, and an investment enters that pocket, only current investors in the fund are entitled to a share in it. Whether a fund has the ability to put specific assets into a side pocket is determined by its constitution. Typically one would expect the directors to have discretion in this regard as side pockets are a useful portfolio management tool that can offer measurable benefits to both investors and fund managers.

A side pocket is simply a separate bookkeeping account used by a fund to segregate illiquid or difficult to value assets, for the purpose of preventing those assets from damaging the returns generated by the other assets. Side pocket assets are not subject to elective redemption. Investors' interests in the side pocket are only redeemed as or when the assets making up the side pocket are realised. They provide flexibility for the fund manager to isolate specific investments until market conditions improve, in the hope that assets can be realised for a better price.

An example of a side pocket creating problems is the case of *FIA Leveraged Fund v. Firefighters' Retirement System (CICA Unreported, February 2013).* Here the investment manager sought to satisfy a redemption request by hiving off highly illiquid assets of the fund into a new company and issuing shares in the new company to its redemption creditors by way of an in specie distribution. The manager argued that this was permissible pursuant to the articles of the fund.

The redemption creditors sought to wind up the fund on the grounds that the distribution of shares in the newly formed company was illegitimate, and consequently a debt remained due from the fund, and on that basis it could be shown to the court that the fund was insolvent. The redemption creditors obtained a winding-up order before the Grand Court in a decision that was subsequently upheld by the Cayman Islands Court of Appeal. The Court of Appeal rejected the argument put forward by the company that the creation of the side pocket and distribution of shares was a valid in specie redemption because the shares of the new company had not been an asset of the fund at the redemption date. On a proper construction of the articles, in order to effect an in specie distribution, the fund must have owned the asset to be distributed in specie on the redemption date.

This case demonstrates the importance of seeking timely advice on the constitutional documents when a fund is considering its options and its ability to create a side pocket.

In specie distribution

The documentation of some funds does not allow them to set up side pockets but there are other options.

"Redemptions in specie" allow a fund to make distributions in kind (e.g. shares) rather than in cash. For example, if a fund holds shares in a particular asset, it might transfer some of those shares to the investors, as opposed to selling the shares and distributing the proceeds. The Cayman Islands Court has upheld the power of a fund to make in specie distributions in accordance with the terms of its articles and offering documents.

Conclusion

Readers will note that there are a variety of tools to navigate the rocky road of a pending rush of redemptions and that the articles of the company are key, as is the interpretation of those constitutional documents. Therefore seeking legal advice at an early stage is crucial. Advice may be needed generally on restructuring options, preparing a strategy, board meetings (and the importance of documenting the same), issues concerning the resignation of directors and, perhaps, placing the company into liquidation and whether provisional liquidation is possible. Directors may want to seek independent advice on compliance with their own duties. If there is going to be a rush on redemptions, creating an effective strategy ahead of time is going to be critical for the survival of the hedge fund.

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