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Initial Thoughts for Fund Managers for 2019: Addressing Liquidity Issues

As financial markets continue to exhibit extreme volatility, it may be time for managers of hedge funds (and other open-ended and evergreen funds) to assess the challenges (and potential opportunities) that may arise in the near future. An obvious challenge is increased redemption requests. Redemptions may not be targeted only at funds experiencing poor performance, but also those with steady or strong returns – with the latter effectively acting as a more stable source of liquidity for investors. Compounding the redemption challenge, many funds have invested increasingly in assets that are, or have become, illiquid. In this context, the following are some initial preemptive steps managers may want to consider:

- 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 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, utilize fund-level or investor-level gates, exercise suspensions rights and use "slow-pay" redemption features.

- Consider 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 vehicle.

- Consider innovative capital retention and raising strategies. For example, implement new classes or sub-classes with lower fees or a combination of lower management fees and higher incentive-based compensation (*e.g.*, "1 & 30" arrangement) and raising additional capital from existing investors for no or little compensation until the fund is back to positive territory ("back to HWM" vehicles).

- Examine your credit lines, including the triggers in counterparty documents. Assess whether there are additional sources of liquidity that could be made available to the fund (*e.g.*, returning unused capital trapped in investments).

- Apprise the fund's board of directors (and/or advisory committees, consulting committees and similar bodies) of the challenges. The more they understand them, the more equipped they will be to act and assist.

- Shrinking asset levels may lead to a reexamination of expenses borne by the fund. Monitor and consider expense allocations in light of the fund's offering documents, Form ADV and compliance policies and procedures.

- Devise a crisis management plan. Among other things, line up a public relations firm in the event it becomes necessary to communicate a new strategy or restructuring.

While there are other alternatives and solutions available that we have not mentioned, there are also sure to be opportunities that arise within this market, such as acquisition of secondary interests at greater discounts.

We hope that you find this overview helpful.

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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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