

Funds in crisis – how do funds manage in times of crisis?

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It has been an interesting two weeks of lockdown for our investment funds team. Many new software applications now demand screen space as we "Zoom" our way through client meetings and "Slack" our progress on projects from offices in our homes across Cape Town. Much has changed. And yet, *plus ça change, plus c'est la même chose*. These tell us that the world will certainly change fundamentally as a result of this pandemic. Below, I have summarised the coronavirus impacts we've been dealing with and how past crises have impacted funds we work with.

Crises are of course nothing new. I wasn't around for Tulip Mania in 1637, the Credit Crisis of 1772, the Great Depression, the 1918 flu outbreak or the 1973 OPEC crisis. But, I was working as a funds lawyer in Paris in September 2001, during the 2008 financial crisis and Bernie Madoff's shenanigans in 2009 impacted many of my clients. I can't help but recognise the similarities between the issues facing our clients today and those faced by our clients in past crises.

The Werksmans investment funds team is unique in that we offer a one-stop shop for funds of all description. We advise private equity funds, pension funds, hedge funds, property funds ... we've even advised wine and art funds. Rather than sending out separate articles for each category of clients, we've sent out one update because in times of crisis, the answer to the challenge facing funds of one type is often found in the experience of a different kind of fund. Hedge funds can learn about how private equity funds deal with restricted liquidity, private equity funds can learn from sidepockets in open-ended funds.

What we've found in past crises is that broadly speaking the following things happen.

Fund documents are scrutinised

We tend to be admitted as attorneys around the time our friends start getting married. One of the first skills we learn is to talk to lovebirds about divorce. But just as fiancés don't want to talk about the bad times, investors and managers often do not want to talk about crises at the start of their relationships. It is only when the crisis hits that the parties to the fund documents start working through the terms.

Those of you who used Werksmans for your fund establishment will no doubt have heard us banging on about matching the liquidity the fund offers investors with the liquidity of the underlying assets. If a fund promises investors that they can redeem their investment on a monthly basis, then the fund needs to be able to liquidate the bulk of its assets on an even shorter basis to be in cash when it comes time to pay the investor. The temptation is always there to offer investors better liquidity than the investments offer and to plug the gap through any number of creative means, including holding a portion of an otherwise restricted-liquidity portfolio in liquid assets or taking an overdraft facility from a bank. Permanent capital vehicles ("PCV"), the current flavour of the month, pose precisely this problem. No investor will let you manage their cash in perpetuity so a PCV must necessarily offer the investor an exit right (usually redemption) of some kind. Many of the current crop of PCV's are looking to invest in restricted liquidity assets and glossing over the mismatch between the liquidity they are offering investor and that of the underlying assets. Some think that by listing the PCV the issue has been addressed.

A crisis represents the proverbial tide going out. Investors and regulators alike tend to look at the fund terms and the fund's investments more critically than they would ordinarily and the reputational risk of falling short of expectations can be fatal for some managers.

Investors look for cash

During a crisis, investors are under pressure to realise liquidity wherever they can get it. We've repeatedly seen some of the best funds forced to close down despite stellar performance simply because investors could get their cash out of the fund. In fact, the best funds are often more susceptible to collapse during a crisis precisely because it is business as usual at that fund and investors can get their cash out. Open-ended funds are of course particularly susceptible. The kinds of massive influx of redemption requests to funds that are still able to redeem investors that is typical in times of crisis generally cannot be dealt with through the ordinary redemption mechanisms. Assuming the extent of redemptions is not such that the fund is obliged to commence an orderly winding-up, there are a number of ways of dealing with significant redemptions.

Gating

Gating can be done at the investor level or the fund level or both.

Investor level gating means that the fund documentation restricts any redemption by an investor to a specified maximum percentage (say 90% of their investment) with the remainder being released on completion of the annual audit of the fund. The purpose behind investor level gating is to recognise that even in an open-ended fund, there will be some restricted liquidity assets in the portfolio that cannot be readily valued accurately.

Fund level gating is a restriction in the fund documentation on the aggregate value of all redemptions that the fund will honour on any redemption day (say redemptions representing 30% of the net asset value ("**NAV**") of the fund). If aggregate redemptions exceed this amount, all redeeming investors are then redeemed pro rata and have the unredeemed portion of their requests held over to the next redemption day.

Freezing Redemptions

Gating cannot of course save a fund in circumstances where a very high number of redemptions has been received. The fund documentation will normally also provide that the determination of the NAV of the fund can be suspended in certain circumstances, including where accurate prices for the underlying assets cannot be obtained or where the directors of the fund believe that it is in the best interests of investors to suspend the determination of the NAV. Since most open-ended funds process subscriptions and redemptions with reference to the NAV/Share value, the suspension of calculation of the NAV effectively stops any outflows of capital from the fund. This, on the basis that if such flows were allowed on the basis of an NAV that the directors know to be inaccurate, the remaining investors in the fund would be prejudiced by the concentration of restricted liquidity assets increasing and the redeeming investors departing before the full effects of the crisis have been factored into the valuation. The suspension of the NAV calculation also has other consequences. In many funds, prudential limits reference the NAV and the fees paid to the investment manager, investment advisors and other service providers may reference the NAV. Because it may be necessary to keep calculating the NAV for the purposes of paying these fees, we normally include a provision in our fund documentation that allows the fund to freeze redemptions without freezing the determination of the NAV.

Side-Pocketing

Once redemptions have been frozen, a fund cannot continue to process subscriptions. On a superficial level, this is because the NAV has been frozen and the NAV is used to establish the price for subscriptions, but even when the NAV has not been frozen, it is dangerous for a fund to accept subscriptions in times of crisis. Any inaccuracy in the price that the subscribing investor pays results in prejudice either to the subscribing investor (in the case of an overstatement of the price) or prejudice to the existing investors (in the case of an understatement of the price). Given that subscriptions and redemptions must inevitably cease during a crisis, the operation of the fund can come to a protracted standstill if the crisis persists and slowly suffocate. In these extreme cases, sidepocketing is frequently the only option available. Sidepocketing must, however, be provided for in the fund documents. Sidepocketing essentially involves the fund allocating the illiquid (or hard to value) assets of the fund to each of the investors in the fund at the start of the crisis and then ringfencing those investors and the matching assets in a separate structure (a sidepocket). This separate structure may be a separate class of shares in the fund company, a separate limited partnership or a separate protected cell in a segregated portfolio company. The main fund will then consist of only liquid, readily valuable assets such that the main fund can recommence processing subscriptions and redemptions while the sidepocket is run down as a liquidating portfolio.

Investors run out of cash

Closed-ended funds that invest in less liquid assets, like private equity funds, generally get a commitment from their investors to contribute capital over time. This means that at least during the investment or "commitment" period, the funds have a claim against the investors for the undrawn committed capital. Even after the commitment period, the expenses of the fund, including the management fees, are paid out of drawdowns from investors. One of the impacts of a crisis is that investors run out of cash and cannot pay when the funds issue drawdowns.

The most obvious impact for funds in this position is their inability to fulfil commitments they may have to underlying portfolio companies. Litigation frequently ensues between the fund and the portfolio company. If the fund is held liable for damages, it may not be able to recover those damages from the defaulting investor and the loss will be passed on disproportionately to the investors who have complied with their obligations. Other impact include a reduction in management fees that puts the general partner/management company at risk, key persons being forced to leave the fund and the fund having to cease making new investments.

Again, there are a number of ways the fund documentation attempts to address this risk. Defaulting investor provisions come in a number of different flavours. Investors may risk forfeiting a portion (up to 100%) of their investment in the fund, the fund may be authorised to sell the investor's stake or to borrow to finance the difference. In many cases, the default will trigger a pre-emptive rights process. Timing is often critical and it is important to make sure that the fund understand and follows the prescribed process to the letter so that no time is wasted. We have a relatively underdeveloped secondaries market (the buying and selling of pre-existing investor commitments to alternative investment funds) in South Africa and it can be a time-consuming process to find a buyer with the interests generally trading at a substantial discount. The change of investor also presents the investment manager with a new investor and a new relationship that it needs to bed down. The process can distract the manager from its principal task of managing investments.

Investee companies suffer

It goes without saying that in a crisis situation many portfolio companies will face novel issues that they may not be properly prepared to deal with. Private equity funds in particular can assist. Hot topics at this point in time include whether or not force majeure clauses and material adverse change clauses (notably in bank loans) are triggered by coronavirus issues and many of the private equity fund managers are assisting the portfolio companies in reviewing all of their contracts in order to determine their exposure.

More regulation

Crises inevitably generate more regulation. Whilst the financial crises of the past necessitated regulatory interventions into financial markets, many regulations were justified by tenuous reference to the financial crisis. In South Africa, a raft of new regulations governing hedge funds were passed ostensibly as a response to the financial crisis when hedge funds demonstrably posed no systemic risk. Even though the coronavirus pandemic is not a financial crisis, its impact will be felt in financial markets and new regulations are already flowing thick and fast. On that note, and in closing, a memorandum has been prepared by Hilah Laskov and Chelsea Roux in our funds team on the [Pension funds distress rules & FSCA operations during lockdown](#). You can find all of Werksmans' notes on the legal implications of the pandemic [here](#).



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