

The Complexities Of Winding Down A Hedge Fund

Law360, New York (April 14, 2017, 12:55 PM EDT) --

Hedge fund mortality is commonplace, yet it is an infrequently examined subject. Hedge Fund Research Inc. has compiled data that shows more hedge funds have closed over the last 10 years than existed at the start of it. Although there is substantial public commentary regarding the formation and growth of funds, many of the complex issues that arise when closing down a fund do not receive the same level of attention. As the U.S. Securities and Exchange Commission considers issuing guidance that could require mandatory transition planning for all registered investment advisers, understanding the various elements of a fund wind-down have become a topic of importance to managers and investors.



Finbarr O'Connor

Our discussion takes us through the reasoning, decision processes and issues faced by the investment manager together with an overview of the challenges and steps involved from the manager's perspective. Although we approach this topic in the context of a hedge fund closure, many of the same issues are also faced by managers and their investors in a private equity fund closure.

Why Do Hedge Funds Close?

Funds shut down for a variety of reasons; most commonly, the cause for closure is related to underperformance. Some funds are fixed-term funds with designated termination dates and defined closure procedures. Certainly, managers seek to shutter operations when AUM (assets under management) declines to levels unsustainable to adequately cover the costs involved in maintaining an appropriate investment management platform (or in some cases fails to initially reach sustainable levels) or when the absolute size of performance fees would not provide acceptable economics to retain the required investment professionals. In addition, a host of one-time events can also lead to fund closure, such as investment team departures, key-man events, regulatory issues and litigation issues.

Whatever the reasoning, the manager and the fund's directors are left with a decision process that must be centered on answering the fundamental question: What is in the best interests of the fund's investors? Passing through this Rubicon, the manager and directors face a myriad of factors that must be addressed.

Not all fund closures are alike and while our discussion of the factors involved seeks to be comprehensive, it is by its nature general. Each fund closure situation typically has its own particular issues; however, some common themes exist and typically involve three overlapping phases:

- Phase 1 — fund closure preparation
- Phase 2 — executing the fund wind-down
- Phase 3 — dissolution of the fund and the platform

Phase 1 — Fund Closure Preparation

Structural Analysis

The decision to close the fund often takes place months, and in some cases years, before the final dissolution can actually occur.

The manager, and in the case of an offshore structure, the directors, having resolved to close the fund, will need to develop a fund wind-down plan and timeline. The wind-down plan largely will be determined by the character and scale of the fund's portfolio and operations. The more complex and diverse the fund is, the more pieces there are to deal with come closure. In its simplest form, a single strategy fund with liquid positions can execute closure and return capital with relative ease, whereas the shuttering of a multistrategy, multijurisdiction-based fund with illiquid assets is typically more complex and consequently involves a significantly longer process.

Closure is not the only alternative for dealing with circumstances that result from a manager deciding to sever its ties with a fund. A manager, or the fund's investors, may consider an orderly transition of fiduciary responsibility over the fund's assets to a successor manager when there are material illiquid investments or contingent assets that require a long holding period to realize investment returns. In such circumstances, the fund would survive under the management of a successor manager.

Analysis of the Fund Documents and Jurisdictional Obligations

An early step will be a situational analysis of the fund, its legal and operating structure, its portfolio, the manager's platform, and investor expectation considerations. An examination of provisions, if any, covering the fund's closure and wind-down included in the fund's governing documents is an important first step. The manager will need to adhere to contractual obligations contained in the fund's documents with respect to winding down the fund. Absent specific provisions, the fund's fiduciaries will need to follow local prescribed legal standards and procedures for the fund's wind-down. Any side letters should be reviewed to assess compliance requirements specific to the fund's wind-down; being cognizant to treat all investors fairly, the manager may wish to provide the same rights to all investors during the wind-down.

Manager SWAT Team

As planning for the fund's closure affects all aspects of the manager's business, the collective input will be required from members of the firm's key functions, including investment and portfolio management, operations, as well as legal and accounting.

Returning Investor Capital

The manager will need to give consideration to the method of returning capital to investors. For Cayman Islands fund wind-downs, the compulsory redemption of investors' interests is an approach that avoids the need for a liquidator to control the process, thus allowing the return of capital to be managed by the fund's board.

Communicating the Fund Closure with Investors and Managing Their Expectations

The manager and the directors will need to develop a thoughtful investor (and perhaps media) communication plan for the fund closure. Advance calls to the largest investors to discuss the closure strategy and distribution timeline may be warranted, but counsel's view should be taken first — managers should avoid providing notice to a select few investors ahead of any redemption notice deadlines. It is critical for managers to provide all investors with full disclosure on the same timeline.

Depending on the level of redemptions and the liquidity of the investments in the portfolio, the directors or manager may decide to invoke the fund's gate (a typical fund provision that allows the manager to suspend or moderate investor withdrawals to prevent a run on the fund's liquidity). Typically, legal, liquidity and distribution analyses will need to be undertaken together prior to instituting the gate. As managers are long aware, being forced to return capital in unstable markets increases asset price impacts in the quest for immediacy. Managers finding themselves in similar uncharted territory may look to the fund's gate provisions as means to protect investor capital from the price impact of a "fire sale." Typically, side pocket assets are structured to be immune from redemption calls providing the manager with more flexibility for investment realization. The manager and directors may also wish to consider distributing in-kind the fund's (final) assets to investors. However, such an approach has significant allocation and operational complexities in practice.

The manager and directors will also need to consider whether any investor consent is required for the wind-down and perhaps develop a lower management fee structure for the wind-down holding period. In addition to modifying management fees, depending on limited partner (LP) subscription terms, the manager may need to seek investor consent to: bring in a successor manager to assist or execute part of the wind-down; modify the frequency or outright suspend net asset value (NAV) calculations; or make other structural changes such as placing residual assets in a liquidating trust.

In practice, the fair and equitable treatment of all investors during the closure carries reputational implications for continuing careers, follow-on funds and associated capital raising. The manager should strive not to overpromise on timing and distribution amounts in order to establish realistic investor expectations.

Other Planning Items

The manager and directors should give consideration to the planning for the ultimate dissolution of the fund structure and the manager platform, planning the final audit and the timeline for distributions, potential tax considerations, and dealing with any associated loose ends such as legal, regulatory filing/issues, ongoing risk management and compliance adherence, litigation, and claims resolution issues that arise in the solvent closure of any business.

Phase 2 — Executing the Fund Wind-Down

The manager and the directors will need to develop the necessary actionable steps to manage the wind-down of the portfolio, the infrastructure of the fund, and the manager itself. The approach to the portfolio wind-down needs to consider investors' expectations, valuation, potential tax issues, regulatory requirements and operating expenses during the wind-down period.

Liquid Assets

Although the investment mandate and portfolio makeup determines the fund's liquidity and hence investor distribution strategy, not all funds populated with liquid-type securities ought to be considered liquefiable overnight. Managers often consider closing out concentrated positions in such securities in a phased manner to minimize negative price impacts. Indeed, the manager may have the conviction that to maximize realization of certain liquid securities, it would be best to wait for an event or events before selling certain individual securities or baskets of securities. For more plain-vanilla liquid securities, the exit can be accomplished in a single call to the fund's prime broker. What is clear from experience, however, is that considerable analysis and planning needs to be applied on an individual investment basis to manage the orderly exit of the fund's portfolio. The manager inevitably will seek to balance the effect of price impacts against the need for immediacy in liquidating a liquid book. For exchange-traded, high-volume securities, the bid-ask spread is usually small because of high transparency and competition for order flow. But, even for supposedly highly liquid assets, an impatient seller may suffer negative price impacts in the quest for immediate liquidity. Market awareness of a fund shuttering can lead also to the potential for front-running by other market participants. For over-the-counter traded securities, the bid-ask spread can be much larger, given the bilateral nature and potentially limited depth of many OTC markets.

Illiquid Assets

The managed runoff of illiquid positions often adds complexity to the wind-down process. Each individual asset or basket needs to be analyzed from a duration and liquidity perspective and assessed for issues associated with the realization timeline that maximizes value, including the closing out of event-driven bets (perhaps short positions). Certainly, for long life assets, such as early-stage PE-style or side-pocketed investments, a value maximizing timeline may be quite long. So, individual asset value maximizing exit horizons are often not aligned with the immediate closure of the fund — funds with more illiquid strategies should establish a timeline to exit each position and consider scenarios that affect time and value realization estimates. The secondary market may provide exit options for those fund investors that are unwilling or unable to hold their interest in the fund through the wind-down period and are seeking liquidity. An active market also exists for the purchase of residual positions, offering the wind-down manager liquidity and bulk trade options, albeit typically at increasing discounts to NAV relative to perceived asset liquidity. The crux of such exit propositions will be a balance between cash discounts to NAV offered compared to the future holding risk and operating costs associated with managing the remaining portfolio assets.

Co-Investments

Often exit terms for co-investment assets are well structured, but seldom do such terms extend to or contemplate the closure of the lead manager. With typical co-investments made on a minority basis by main fund LPs on longer tail assets, the decision to begin a managed exit of the fund and the manager platform raises a host of issues, not least of which is the co-investee's expectations on the timing and steps to achieve the harvest event. These issues will need to be worked through by the wind-down manager and the co-investee.

Management of Relationships with Key Fund Service Providers and Market Counterparties

The proper planning of the fund wind-down will call for advice from the fund's key professionals and trusted advisers. The fund's outside counsel will be an early call to assist in the planning of the wind-

down framework by analyzing and interpreting any wind-down provisions included in the fund's governing documents as well as advising on the applicable laws and regulations generally relating to entity dissolution. Other professionals, such as the fund's auditors and tax advisers, will need to be consulted as a second early planning step. The decision to disclose the fund's closure to other service providers and counterparties needs to be evaluated and subsequent relationships managed carefully. What is clear from experience is that certain parties will quickly lose interest in the fund platform if they perceive no ongoing money-making relationship, client or brokerage. In addition, managers should be mindful of the potential of an informed market front-running the wind-down of certain publicly traded 13F disclosed positions.

Leverage and counterparty relationships also may play a role in determining the approach to managing the exit of portfolio assets. The manager may need to consider the extent and form of leverage with any financing counterparties, and perhaps any break funding costs if applicable, in determining the timeline and approach to individual asset or entire portfolio liquidation. The manager should review all counterparty agreements, including ISDAs and related agreements to evaluate consequences of the fund's wind-down. Prime lenders may aggressively manage down lending exposure to funds that are expected or known to be in runoff, potentially effecting the manager's ability to manage the timing of exits from leveraged positions.

Fund Contractual Obligations

The manager should identify and make provision to settle all fund contractual agreements (such as service providers) and contingent fund obligations. A similar analysis of and the steps to settle the manager entity's obligation should be undertaken.

Investment Manager Platform

Many issues need to be addressed in the closure of the manager platform. Typically, such issues can be categorized into three broad buckets: people, assets and overhead. The manager will need to ensure that the appropriate investment team and supporting back/middle office staff are in place to manage the disposition of both near- and longer-term asset portfolios as well as ongoing investor distributions. Retention and compensation considerations are core to assuring that the appropriate staff is retained as necessary through the completion of the wind-down. The manager will also need to consider a plan to retain investment professionals key for the oversight and management of the portfolio over the course of the wind-down. With a highly competitive market for skilled investment managers, it is not uncommon that soon after a closure announcement funds experience an exodus of personnel, often recruited by a very active headhunter community. Even in advance of a portfolio closure announcement, the departure of key investment professionals may trigger key-man redemption terms in some LP side letters, creating an additional demand to generate funds to meet the associated redemption requirements.

A significant element in the fund platform's wind-down will be consideration of the manager's contracts and obligations, the largest of which is often office lease obligations. An analysis of the manager's remaining obligations under its office leases will need to be married to the manager's office space requirements during the wind-down period. Depending on the willingness of landlords to provide modifications to existing lease terms, alternatives such as partial or complete subletting and relocating may need to be considered.

A line-by-line review of operating expenses to determine the extent and timing of overhead

reduction/elimination will be a core planning step for the manager's chief financial officer/financial manager tasked with developing the wind-down budget.

The manager typically does not have a significant balance sheet, although the need for and the eventual disposition of infrastructure assets, such as information technology, communication equipment and furniture will need to be addressed as part of the wind-down plan.

Communicating with Investors During the Wind-Down

The manager should plan for detailed and frequent updates on the status of the wind-down, NAV and distributions, perhaps through its investor portal or quarterly investor letters. Such communications will serve to manage investor expectations, through perhaps unfamiliar territory for some, during the course of the wind-down period.

Phase 3 — Dissolution of the Fund and the Platform

Exiting Residual Assets

Following the heavy lifting to finalize the exit and marshaling of sales proceeds of the fund's remaining significant investments, the manager will need to close out any asset-level counterparty relationships, finalize liquid and illiquid asset transactions and disposition tails, and exit any stub or immaterial assets. Should a market for the exit of residual assets not materialize, the manager may wish to consider placing such assets in a liquidating trust. Such a trust can provide a streamlined and cost-effective solution to warehouse residual assets requiring limited oversight.

Resolving Final Fund Liabilities

A key element in the solvent liquidation in any fund vehicle (or indeed the manager entity platform) will be the resolution of remaining liabilities. To the extent that any fund entity has potential contingent liabilities, the directors or manager will need to assess the likelihood of such liabilities crystallizing into actual monetizable claims and, depending on the magnitude of such potential claims, the fiduciaries may be well-advised to set aside reserves to address such identified potential claims during the pendency of the fund's dissolution.

Liquidating Audit and Final Investor Tax Statements

One of the final steps in the wind-down of a fund is the liquidating audit. The fund is required to undertake a final liquidating audit, and the manager will need to liaise with the fund's audit professionals to assure that the audit is conducted in a timely and efficient manner. In addition, the manager will need to liaise with the fund's tax professionals for preparation of K-1s or passive foreign investment company (PFIC) forms, as well as the fund's final tax returns. The Financial Accounting Standards Board requires entities to use the liquidation basis of accounting for financial reporting purposes once a decision has been made to formally dissolve a reporting entity; this often requires changes in both presentation and disclosure. Notably, under the liquidation basis of accounting, the manager must accrue for the estimated cost to dispose of assets plus any costs it expects to incur through the end of the liquidation as and when such costs become reasonably estimable. For offshore funds, the manager may also need to cancel its Foreign Account Tax Compliance Act (FATCA) registration.

Dissolving Fund and Manager Entities in Accordance with Requirements of Applicable Jurisdictions

Prescribed procedures typically exist for both onshore and offshore fund entity dissolution. Under Cayman Islands law, two dissolution mechanisms exist: the customary approach is the voluntary winding up of the legal entity whereby the directors resolve to wind down and a liquidator is appointed to manage the formal process. Alternatively, a separate dissolution procedure known as “striking off” exists in the Caymans where the Register of Companies commences the formal entity dissolution following the directors’ request. The dissolution of an onshore solvent entity, often a limited partnership or limited liability company organized under Delaware law, commences with an affirmative vote of the entity’s majority (or otherwise requisite) owners. All outstanding obligations and contingent claims, together with provision for any future claims that may be known to the company, must be affirmatively resolved, either through actual payment or compromise. If a potential liability is subject to dispute, it must be resolved through settlement or cancellation through mediation, arbitration, or a judicial ruling from litigation. While not a legal requirement, it is prudent to notify all of the entity’s creditors, whether via a written notice or by publishing a notice in one or more local newspapers. Once all final liabilities are satisfied (or adequately reserved for), the manager can distribute any remaining assets to the entity’s owners/members. A member who receives a distribution from a limited liability company may be subject to a clawback if an action against such member is commenced prior to three years from the date of the distribution. The final stage is completed following the filing of a certificate of cancellation with the Delaware Division of Corporations, which effectively dissolves the corporate existence of the entity.

Manager Wind-Down

If there is no continuing use for the manager platform, the manager will seek to withdraw its registration with the SEC through the filing of the Form ADV-W.

Maintaining fund records in accordance with regulatory requirements — SEC Rule 204-2 governs the retention and preservation of records — in particular includes the following requirements:

1. Storing the records for five years, with the first two years in an appropriate office of the adviser;
2. Indexing the records for easy search, access and retrieval; and
3. Maintaining duplicate copies of electronic records on indelible storage media to safeguard against loss, alteration or destruction.

Final Investor Distributions

Alongside the dissolution process, and following the liquidating audit, the fund’s liquidating manager will process final investor distributions and circulate final investor notices. Assuming the fund has not determined to retain any holdbacks to address contingent matters, the receipt of this distribution and capital statement, together with their copy of the liquidating audit and K-1s, will typically be the last formal interaction investors will have with the fund.

Final Thoughts

Fund managers are experts at raising and investing capital; a wind-down is essentially the other side of the looking glass — divesting investments and returning capital. The wind-down of a fund is no simple undertaking and requires the skillful input from a variety of sources, including attorneys with both

regulatory and practical wind-down experience, accountants and tax advisers, and financial professionals with expertise in winding down the affairs of funds and their managers. Fiduciary duties continue throughout the process to monetize investments and return investors their capital. Managers are well-advised to seek the assistance of wind-down experts to assure an orderly and efficient process and to provide comfort to both investors and regulators that investment realization is maximized and that statutes and other governing law is adhered to.

—By Finbarr O'Connor, Berkeley Research Group LLC

Finbarr O'Connor is a managing director at Berkeley Research Group and leads the firm's private funds advisory practice group based in New York. He specializes in the management of tail-end funds.

The views and opinions expressed in this article are those of the author and do not necessarily reflect the opinions, position, or policy of Berkeley Research Group LLC, its other employees, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

All Content © 2003-2017, Portfolio Media, Inc.