



A Run on Hedge Funds: Redemption Strategies and Responses

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The global economic crisis has had a significant impact on the hedge fund world. One of the most striking developments has been the rush by many investors to redeem their holdings. Individual and institutional investors alike, in reaction to dismal returns on their investments (the average fund has lost 20% this year), have engaged in a classic run on the bank. In response, dozens of hedge funds have suspended or restricted redemptions – if such actions were authorised by their governing documents.

Preventing an investor from exiting a fund, unless the investor had a reasonable justification (eg a legal requirement or financial emergency), was once anathema to all but the weakest funds, as it was often taken as a sign that the fund was in distress and might even collapse. In the current environment, even a giant, public fund like Fortress has been forced to take this defensive measure. In a 3 December 2008 SEC filing, Fortress Investment Group announced that it had suspended redemptions from its largest hedge fund and three of its feeder funds, stating that “the boards of directors and general partner of the applicable feeder funds have evaluated the most appropriate course of action to take in response to the requested redemptions in light of applicable requirements and current market conditions, and have acted unanimously to temporarily suspend pending redemptions from the fund.”

In addition to Fortress, a growing list of funds have announced suspensions of investor redemptions in the second half of this year. The US\$10 billion Tudor BVI Fund announced that it halted redemptions until it finalises a restructuring to isolate “toxic assets”. DE Shaw Group, Farallon Capital Management, RAB Capital, Legg Mason’s Permal Group, Centaurus Capital, Gottex Fund Management, Highbridge Capital Management, and Goldman Sachs/JP Were Managed Funds Ltd are just some of the major asset managers around the globe that have suspended redemptions from their respective funds.

While investors are seeking to shift their hedge fund investments into cash or fixed income instruments, many hedge fund managers point out that being forced to return their investors’ assets whenever such demands are made would require them to sell securities into an unstable market, often at bargain basement prices, and that would harm other investors who were not looking to cash out. Such a situation may force the hedge fund to liquidate potentially very profitable positions at huge losses, thus accelerating the deterioration of the fund. Furthermore, large amounts of stock sales can intensify further market declines and bring further damage to the economy at large.

15 November was so-called “Redemption Day” for most funds – the final day when investors could ask to get their money back by the end of the fiscal year. Whether you are a manager of an existing fund with notifications of redemption piling up, or contemplating to start a new fund, the time to formulate strategies for dealing with redemptions has never been more critical.

Review Your Redemption Provisions

We are not suggesting that investors’ cannot have access to their capital accounts – after all, they invested, not gifted, their money to your fund. However, the ability to professionally manage a fund and fulfil your fiduciary duties for all beneficial owners requires a systematic process of withdrawal that does not encumber the fund. Furthermore, there must be processes for contingencies, such as the economic tsunami that has occurred.

The very first step is to conduct a thorough review of your fund documents. Hopefully, your fund is protected with strategies to keep your investors from unilaterally withdrawing assets and leaving your fund vulnerable. Even if you are comfortable that you fully understand the terms of the offering documents, subscription agreement and governing agreement, it is prudent to have an outside attorney assist the fund in this exercise. We also suggest that it makes sense to have a different, let’s say more objective, set of eyes review your documents.

The initial provision to analyse is the lock-up, a key feature that nearly every hedge fund has. The lock-up requires that new investors agree to a minimum period of time during which their money invested in the hedge fund is committed and cannot be withdrawn. The length of a lock-up period may depend on the quality and reputation of the fund, as well as the liquidity of the underlying investment portfolio. Some funds



may allow investors to redeem during a lock-up period if they pay a penalty (redemption fee), generally 3-5% of the amount of capital they are seeking to redeem.

Redemption requests are conditioned upon a requirement to give notice (generally 45-120 days) to the manager that the investor wishes to redeem all or a portion of its capital account on the given redemption date. These notices are generally irrevocable once delivered and are unconditional. It is important to examine the notification provisions, since the manager can have the discretion to ignore an inadequate notice.

If your fund is allowed to invest in illiquid securities these provisions should be carefully reviewed, as they impact the investor's redemption right. At the time an illiquid investment is made, a proportionate share of an investor's capital account, vis-à-vis the entire capital balance of the fund, is assigned to a special memorandum capital account (also called a side pocket account, designated account or special investment account) for that investor. It is typical for an investor to lose redemption rights to the side pocket account and even a request for full redemption will be satisfied only with the capital applicable to the investor's non-side pocket capital account.

All well-crafted fund documents should allow the manager to suspend or restrict the right of any investor to redeem interests. Full suspensions or other restrictions can be imposed at the manager's discretion or subject to certain pre-conditions.

Governing documents typically contain a valuable protection referred to as a redemption gate. This mechanism is used by hedge fund managers to limit the percentages of capital that can be withdrawn on the fund's scheduled redemption date, or to delay or suspend withdrawals altogether where there is a possibility of a "run" on the fund's capital.

Redemption gates are often imposed at the discretion of the fund manager to bar investors, for any reason, from removing any but a portion of their original stake in a firm over a period of time or delay the payment of redemption proceeds to investors. Other gates are drafted as a non-discretionary mechanism exercisable only in specified circumstances. For example, redemptions may be prohibited if the exchange on which any significant portion of the fund's investments are trading is closed, or trades are restricted or suspended. Redemptions may also be refused if the manager reasonably believes that the net asset value of the fund investments cannot be fairly ascertained, the redemption or realisation of the fund's investments cannot, in the manager's opinion, be effected at normal prices or normal rates of exchange, if certain adverse regulatory conditions emerge, or if there are negative tax consequences to the redemption. In certain provisions, a redemption gate allows the manager to limit investor withdrawals to a ceiling of between 10% and 25% of quarterly assets. Redemption requests made above such percentage will generally be deferred until the next redemption day, subject to the manager's exercise of its discretion to suspend redemptions altogether.

Fund offering documents should provide substantial disclosure regarding the triggering circumstances for redemption gates and describe when standard redemptions will resume.

Taking the foregoing into account, you should next review any private agreements between the fund and an investor (side letters). A side letter may have unique terms that modify the fund's terms, including the standard lock-up and redemption gate.

Sweetened Terms

Even if redemption requests are pouring in, there may be an opportunity to negotiate with the investors. Another approach to retain investor capital and stave off redemptions is to consider reducing management and/or performance fees or modifying high water marks (levels that must be topped before managers can be paid their performance fees).

Many fund managers understand that investors that have faith in an investment strategy may be persuaded to ride out the storm if the economics of their deal are adjusted. For example, it was reported that Camulos Capital, in the wake of significant redemption requests, made a restructuring proposal to its investors to cut its management fee from 2% to 1.2% and its performance fee from 20% to 10% from 1 October 2008 through 2010. Ramius Capital, according to an industry newsletter, offered its existing investors who agreed to a new two-year lock-up a 5% reduction in its performance fee and those who invest additional money will



pay no incentive fees at all on the new investment until the beginning of 2010 – thereafter, the rate will rise to 10% and then 15% at the end of 2001.

The options in re-negotiating fees and other terms can vary widely depending on the strength of the fund and the relative position of each side. It is important to remember that such adjustments must be fair to all investors, as a manager is a fiduciary to all beneficial owners of the fund.

Communicate Wisely to Investors

The communications to investors regarding the imposition of a redemption gate or suspension, or offer to modify fees and other terms, should be carefully worded. Investors in this economic environment can be very frustrated and only a quick enquiry away from a plaintiff's attorney. It is important to review the content of any letter to investors with the fund's counsel to ensure that the tone is appropriate and the substance conforms to the fund documents.

The current environment is very difficult for the hedge fund industry, but new funds are still being formed and many existing funds are taking a conservative and prudent approach to investment management. The right investor relations will go a long way to maintaining your business and finding success for the eventual economic turnaround.

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