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Legal and Business Insights for Asset Managers During the COVID-19 Pandemic

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June 2020

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Introduction

- Fundraising
- Key Considerations for Private Equity and Other Closed Fund Funds
- Issues for Open-End Funds
- Portfolio Company Issues
- Special Regulatory Considerations

Guiding Principles

- **Hindsight is 20/20**: Fund managers should assume that--especially in times of economic uncertainty--most, if not all of their actions, will be scrutinized by investors, regulators and counterparties with the benefit of hindsight.

- **Butterfly Effect**: None of the issues being presented can be addressed in a vacuum. Private fund managers should fully consider how potential solutions to one issue might impede or enhance their ability to address others—especially when making mission critical decisions.

- **Communication**: Regular proactive communication with investors and Portfolio Companies is critical.

Key Fundraising Considerations:
Current State

As the past weeks and months have unfolded, we are getting a fuller picture of the implications of COVID-19 on what had been a relatively frothy fundraising environment.

What is happening? Are funds closing?

- Yes. Funds are closing, and in some cases are accelerating their timing for closing.
- There is particular interest and activity in distressed and other opportunistic plays.
- While some hedge funds are addressing withdrawal requests, others are seeing inflows of capital to take advantage of current market opportunities.

Where are the weaknesses? Are there certain funds and/or sponsors most vulnerable?

- Limited partners have not shut down and we have not seen a major slowdown due to the “denominator” effect, or otherwise.
- Virtual marketing and due diligence.
- Difficulty if a significant amount of diligence was not completed pre-COVID and/or a legacy relationship does not exist.

Key Fundraising Considerations:
Investor Portfolio Challenges

The impact of COVID-19 has resulted in incredible volatility and significant market dynamics that have had ripple effects across investment portfolios and have posed specific challenges to allocations to alternatives.

- **Limited Time**. Limited Partners are in triage mode tending to existing portfolio.
- **Liquidity**. The management of liquidity remains a top focus for investors.
- **Allocation**. The relative allocations to alternative assets will be mismatched in the short-term. Investors have experience with this "denominator" effect from the GFC. Concerns of an over-allocation to alternatives are mitigated by the learnings from the GFC.

Sponsors should focus on transparency and communication with investors on pipeline and capital deployment plans.

Key Fundraising Considerations:
Marketing Considerations

Despite ongoing uncertainty and unknowns, sponsors need to reassess their marketing materials to account for the short-term and potential long-term impact of COVID-19.

- **<u>Has the investment opportunity changed?</u>** Are there additional factors to highlight in the context of the investment process/opportunity (*e.g.*, sourcing portfolio investments; managing portfolio companies).
- **<u>Track record review.</u>** In addition to complying with its valuation policy, sponsors must be prepared to dig into each portfolio holding to determine if the valuation is fair and meaningful.
- **<u>Sponsors should review their marketing materials and fund governing documents</u>** (including conflicts disclosure and risk factors) *de novo* in light of the changed environment.

Key Fundraising Considerations:
Fund Terms

Sponsors should apply what is being learned from COVID-19 and ensure that their fund documents include the appropriate terms to permit them to properly navigate their duties to maximize returns to investors.

- **Time period extensions:** fundraising period; investment period.
- **Maximizing investment opportunity:** new opportunities in distressed markets.
- **Managing LP liquidity:** use of subscription facilities.
- **Supporting portfolio companies:** reinvestment provisions; limitation on follow-on investments.

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Key Considerations:
For Private Equity and Other Closed End Funds

Private fund managers are likely to feel multiple pressure points as they manage their portfolios and interact with their LPs in the near to mid-term. We will explore key considerations in the following four areas:

- Portfolio Valuations
- Portfolio Funding Requirements
- Fund Financing
- LP Communications and Transparency

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Portfolio Valuations

- LPs and regulators are hyper-focused on the integrity of portfolio valuations.
- Writedowns could have several negative knock-on effects for private fund managers creating perceived conflicts that could compromise the integrity of their valuations.
- Critical for private fund managers to follow their valuation policies to the letter, and be transparent about potential changes in values as the full impact of COVID-19 is realized.
- Valuations by independent experts may be prudent to allay LPs concerns over valuation methodologies and potential conflicts.
- Private fund managers are now more likely to need LPAC/LP approvals on a variety of matters, such as investment restriction waivers, cap increases and amendments. LPs should be expected to dig deeper into valuations before granting any approvals that could put their investments at further risk.

Portfolio Funding Requirements

Portfolio companies will need fresh capital to address consequences of the pandemic, and a confluence of restrictions in fund documents may impede a private fund manager's ability to satisfy these funding requirements.

- Size and duration limits on follow-on investments
- Recycling limits
- Diversification, geographic and other investment restrictions
- LP defaults
- End of fund term

Alternative liquidity sources may be available.

- Sidecar funds and coinvestment SPVs
- Fund-level and portfolio company-level fundraising
- Fund-level capital call facilities and NAV financing
- GP-led secondaries
- Successor funds and continuation funds

LP Communications and Transparency

- Investors are also under pressure to stay on top of fund and portfolio company issues over which they have no control.
- Proactive managers that go beyond fund-level reporting requirements by providing transparency into portfolio company health and solutions being implemented to address consequences of the pandemic can reinforce the manager's institutional reputation and demonstrate it has the situation under control.
- Even in a best-case scenario, investors should be expected to raise questions requiring substantive (most likely financial) responses making it vital for managers to do their homework in advance and provide consistent responses.
- Fund managers will need to balance a desire for increased transparency with confidentiality restrictions imposed by portfolio companies and the fund's governing documents.

Managing for Success

- Whether preparing to fundraise or in the midst of fundraising, sponsors must maintain and strengthen their relationships with investors and strive to develop new relationships with investors. Communication is key.

- Sponsors should take the opportunity to scrutinize their operations and processes to determine best practices, and review and revise fund documents to align accordingly.

- Investment opportunities may exist outside the fairway. Private fund managers should review their marketing materials and fund documents to assess whether their funds can take advantage of these opportunities.

- Many current alternative financing and structuring solutions were not available during the GFC. It is important to understand the pros and cons of each, and conflict issues. Early and open communication with investors is key.

Issues for Open-End Funds: Liquidity Issues and Withdrawal Requests

Overview:

- Pending Liquidity Requests; Planning for Future Withdrawal/Redemption Requests
- Secondary Transactions and Other Sources of Liquidity in "Suspended" Open-End Funds
- Onshore versus Offshore Structures – Issues to Bear in Mind
- Fund Distribution Provisions and Other Options – Portfolio Liquidation Issues

Issues for Open-End Funds: Liquidity Issues and Withdrawal Requests

Pending Liquidity Requests; Planning for Future Withdrawal/Redemption Requests

- Managers should evaluate (i) pending and potential withdrawal requests from investors, (ii) withdrawal notice provisions, (iii) timing requirements for distributions of withdrawal proceeds, (iv) which investors are exposed to side pockets, and (v) any special provisions in fund documents regarding distributions in kind, liquidating vehicles, etc., discussed in more detail below.
- Understand in greater detail the current composition of the fund's portfolio. A hedge fund may have a combination of liquid and illiquid positions, and may bifurcate the portfolio in connection with withdrawal rights. Managers need to be more well-informed and active than usual with respect to their investments and the evolving risk of liabilities from their portfolio companies (example, potential claims against the fund as owner of portfolio company).
- Study the mechanics of available gating provisions (investor level/fund level).
- Understand requirements for a suspension of withdrawals or calculation of NAV including (i) triggers required for implementing suspension, (ii) notice provisions, (iii) timing requirements and (iv) fund continuation post-suspension.

Issues for Open-End Funds: Liquidity Issues and Withdrawal Requests

Secondary Transactions and Other Sources of Liquidity in “Suspended” Open-End Funds

- Fund managers should attempt to estimate the length of any suspension and consider how to communicate with investors (and take into account any notice provisions required by their fund’s documents);
- Clear communications regarding rationale for suspension;
- Some fund investors may have transfer rights pursuant to side letters;
- Targeted secondary transactions to address needs of specific investors and need to balance duties to all investors in light of existing conflicts disclosure;
- “Tender offer-style” transactions – third party offers to purchase interests from investors in suspended fund at NAV.

Issues for Open-End Funds: Liquidity Issues and Withdrawal Requests

Onshore versus Offshore Structures – Issues to Bear in Mind

- Manager should pay special attention to differences in documentation between any onshore and offshore vehicles in a master/feeder or more complicated fund structure. (For example, the Articles of Association of a Cayman company may include requirements not present in the onshore documents.)
- Presence of independent directors adds another layer of scrutiny and approval requirements when gates or suspensions are involved.
- Filings may be required in non-US jurisdictions when a suspension is implemented.

Issues for Open-End Funds: Liquidity Issues and Withdrawal Requests

Fund Distribution Provisions and Other Options; Portfolio Liquidation Issues

- Distributions of “slices” of the portfolio, liquidating trusts and distributions in kind (be aware of side letter requirements).
- Involve practice area specialists when needed. Even a hedge fund with a fairly liquid portfolio may be in a situation requiring expertise from specialized legal counsel (e.g., derivatives, tax, litigation, restructuring and credit experts); portfolios may be more complicated to unwind.
- Fund documents may permit the fund to avoid or delay liquidating positions to avoid impairing realization value.

Portfolio Company Considerations:
Managing Fiduciary Duties

Overview

- Likelihood of increased scrutiny of decisions by directors and sponsors/funds in a liquidity crisis or economic downturn
- Sponsors should prioritize portfolio companies in which they have a board designee and/or a significant ownership of interest

Fiduciary Duties owed by Director

Fiduciary duties may be owed by directors to portfolio company and minority shareholders

- Variations by jurisdiction but typically include duty of care and duty of loyalty

Fiduciary Duties owed by Fund/Sponsor

Fiduciary duties typically not owed by fund/sponsor to portfolio company or shareholders

- Note potential exceptions, including for "controlling shareholders"

Portfolio Company Considerations:
Managing Fiduciary Duties

Significant decisions invite increased scrutiny

- Change of control or other significant corporate transaction
- Allegations of conflict of interest

Decisions can be judged by different standards

- Business Judgment rule
- Entire Fairness doctrine

Potential steps to mitigate risk

- Appointment of additional independent and unconflicted directors
- Retention of outside advisors and consultants
- Special committee to oversee transaction or represent minority shareholders
- Consent from majority of unconflicted minority shareholders

Portfolio Company Considerations:
Assessing Insurance and Indemnification

Inventory

- Create list of all portfolio companies and sponsor-appointed board designees
- Compile all documents that could extend insurance or indemnification to both the director and the fund complex
    - At the portfolio company level; At the fund level; At the GP/sponsor level

Prioritize and Assess

Focus on higher risk portfolio companies

- Portfolio companies with sponsor-appointed board designees; Portfolio companies in distress; Portfolio companies approaching or considering significant events
- Perform comprehensive review
    - Coverage, Limits, and Exclusions
    - Priority as between other forms of coverage
    - Specific attention to portfolio company level

Looking Ahead

- Ensure that all policies remain effective and all premiums are paid
- As renewals approach consider options to optimize coverage

Special Regulatory Considerations

- SEC June 2019 Interpretive Guidance — Fiduciary Duties
  - Duty of Care - (i) the duty to act/provide advice that is in the best interest of the client, (ii) the duty to seek best execution, and (iii) the duty to provide ongoing monitoring.
  - Duty of Loyalty – (i) full and fair disclosure of all material facts relating to the advisory relationship, and (ii) must eliminate or at least expose through full and fair disclosure all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which was not disinterested and (iii) an adviser may satisfy its duty of loyalty by making full and fair disclosure of conflicts of interest and obtaining the client's informed consent.
- Conflict of interest disclosure – evaluate current disclosure in fund documents and effects on the adviser's personnel which may require disclosure (e.g., review key person provision and Form ADV Part 2A to determine whether updates are warranted).
- Managers should discuss with counsel conflicting investor sensitivities (e.g., a long-term investor like a large pension plan versus a fund of funds with more immediate need for liquidity) in the context of withdrawal requests, gates and suspensions.
- Consider updates to compliance manual (i.e., business continuity plan, cybersecurity, etc.). Determine whether any COVID-19 related updates are needed) and permissible means of disclosure.