



Managing  
Liquidity

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## MANAGING LIQUIDITY

This article outlines various solutions for Irish hedge fund and fund of funds managers when faced with severe liquidity pressures brought on by the current financial climate.

One of the greatest challenges faced by hedge funds in 2008 has been to effectively manage liquidity in the midst of extremely difficult market conditions, an unprecedented credit squeeze and increasing investor redemptions. There has been no exception to this for funds domiciled in Ireland.

Below we examine some of the options Irish hedge funds and fund of hedge funds (FoHFs) can use when faced with severe liquidity pressures. Some funds have needed to look beyond the conventional options for more resourceful ways of protecting the integrity of the fund and the interests of investors. Fund promoters, legal advisers, service providers and the Irish Financial Services Regulatory Authority (the “Financial Regulator”) have been working to find solutions that are commercially viable yet ensure fair and equal treatment of both the redeeming investors and those remaining in the fund.

### Liquidity Pressures

The dramatic slide in market prices, the pressure to deleverage, short selling bans and the increased cost of borrowing are all some of the factors that have negatively affected hedge funds this year. The result for many has been poor performance and this, in turn, has led to an increase in the level of redemption requests and a need for liquidity to fund such redemptions.

Many funds are carrying investments that have quickly become illiquid. For hedge funds, this may involve a distressed asset that is not capable of being realised or where immediate realisation would only be possible at a significant discount. For FoHFs, this would typically involve an underlying fund suspending valuations and/or redemptions. In each case, the fund will either not wish to liquidate the position or will not be in a position to do so.

Where a portion of a fund’s assets are liquid, it needs to be careful before it considers funding redemption requests only from the liquid portion of the fund as a consequence of this will be that the remaining investors will receive an increased exposure to the illiquid portion.

## Standard Liquidity Control Options

Increasingly, funds have sought to apply measures to control the level of redemptions to be met and to address scenarios where some or all of the funds' assets are illiquid.

The prospectus and constitutive documents of hedge funds and FoHFs will typically provide for a range of liquidity controls measures. Below is a summary of some of the standard measures:

### *Redemption gates*

An Irish fund may reserve the right to limit the amount of redemption requests that it will be obliged to process per redemption day (25% for a quarterly dealing fund and 10% for a fund that deals at least monthly).

### *In-specie redemptions*

Redemption proceeds may be paid wholly or in part in specie (transfer ownership of underlying assets directly to redeeming investors). This will generally require the consent of the particular investor but can be without investor consent where the redeeming investor requests the redemption of shares representing 5% or more of the fund's assets. The assets must be sold by the fund however, if the investor so requests.

### *Credit facilities*

Temporary borrowings may be used to settle redemptions. However, with credit sparse, this option may not be practical and gearing may exacerbate liquidity risks.

### *Holdbacks*

An Irish FoHF may holdback up to 10% of redemption proceeds, if this mirrors the redemption policy of the underlying fund until such time as the full redemption proceeds from the underlying fund are received.

### *Write downs*

This would involve valuing an illiquid asset at zero and disposing of it. A fund can avail of this facility if satisfied that there is no possibility of any value being realised from the asset.

### *Temporary suspensions*

Seen as a last resort, a fund may temporarily suspend valuations and dealings in certain circumstances (prescribed in its prospectus and constitutive document). Such circumstances may include where the fund is unable to repatriate funds required to pay redemptions.

## Other Options Now Being Considered

Where the standard options do not adequately address the issues presented in any particular case, Irish funds have started to explore alternative options. Below is a brief outline of some of these options:

### *Side pockets*

This involves moving the illiquid/difficult to value assets into a separate compartment within the fund's portfolio so that only investors in the fund at the point of the side pocket's creation may thereafter participate in the gains and losses of the assets in the side pocket. This enables investors to continue to subscribe into and redeem out of the liquid portion of the fund.

Side pockets are generally considered to be the most equitable solution for investors, however they are not without their administrative challenges and do not address every issue from the perspective of ensuring fair treatment of investors.

### *Spin outs*

This would typically involve the use of a special purpose vehicle (SPV) that either (a) acquires the illiquid assets directly; or (b) enters a participation agreement with the fund and acquires future proceeds from the illiquid assets. In each case, the fund receives shares in the SPV that are transferable and can be paid out in specie as part of a redemption. Option (b) would assist where the illiquid assets are non-transferable.

### *In specie dividends*

Funds can avail of a facility to distribute the illiquid assets among all investors as in specie dividends. Typically, approval of a majority of shareholders at a general meeting will be required. Also, the assets must be sold by the fund, if the investor so requests. Taxation of dividends for specific investors may also be a consideration.

### *Lowered redemption gates*

Irish non-UCITS funds may apply gate levels lower than the standard 10%/25% levels mentioned above, when under severe liquidity pressures, provided the fund acts in the best interests of investors.

### *Conversion to limited liquidity*

Subject to shareholder approval, the financial regulator will permit open-ended funds (funds that deal on at least a quarterly basis) to convert to limited liquidity funds.

Limited liquidity funds are required to value their assets at least twice annually but no regulatory requirements are imposed in terms of dealing frequency or settlement timeframes for redemption proceeds. They are distinguished from closed-ended funds on the basis that they do not have a finite life span and offer redemptions at some point. A fund that offers redemptions at least annually can be described as “open-ended with limited liquidity”.

### *Promoter bail out*

Another option that may be considered is for the illiquid assets to be purchased by an associated party. The assets cannot be sold to an associated party for anything less than an arms' length price but, provided the transaction is in the best interests of shareholders, the sale of an asset at market value or higher would be permitted.

## Capacity to Act and Investor Disclosure

In every case, the fund will need to ensure that the proposed action is within the scope of its powers. Where such capacity is not present, it may be necessary to update the fund's constitutive document before availing of the measure.

It is also necessary to ensure clear disclosure to investors of actions taken. In the case of side pockets, reduced redemption gates and certain other non-standard measures, for non-UCITS funds, the Financial Regulator will not require investor approval is obtained, however investors must be notified. Such notification may be after the event. In addition, the fund and its trustee must each confirm to the Financial Regulator that the proposed action is in accordance with the fund's rules and takes into account the interests of all investors (Letter

from the Financial Regulator to the Irish Funds Industry Association dated 4 December, 2008 regarding liquidity issues for Irish authorised funds).

## The Rise of the Limited Liquidity Fund

As well as seeing some conversions to limited liquidity, as discussed above, the number of new Irish funds being created as limited liquidity funds has increased significantly in 2008.

Particularly in the area of FoHFs, promoters are increasingly seeing the flexibility of limited liquidity funds as a pre-requisite and investors are increasingly accepting that the liquidity scope required to effectively manage a FoHF may often place them outside the open-ended range.

## The Outlook

Against the current backdrop of political calls for increased regulation of hedge funds and broad industry consensus on the need to raise standards within the industry, Ireland is poised to build on its reputation as a regulated jurisdiction that maintains high standards of regulatory oversight while providing an environment in which the Financial Regulator and hedge funds alike can adapt to the challenges that the rapidly changing markets present.

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