MARCH 24, 2020

COVID-19: Considerations for Investment Funds

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The COVID-19 pandemic will affect managers of hedge funds and other similarly structured open-ended private funds in a number of ways. The nature and extent to which any particular fund and its manager are affected by COVID-19 will depend on the stage and maturity of the fund, the investment objectives and strategies of the fund, the investor base of the fund and other factors.

Set out below are some issues that open-ended private fund managers may wish to consider in light of the COVID-19 pandemic.

Considerations for Existing Funds

Investor Relations

Communication with Investors

- As the COVID-19 pandemic evolves, it will be critical for managers to engage with their investors in an open and transparent manner. Each fund sponsor should be prepared to respond to questions about the health of its portfolio, the actions taken to mitigate exposure, and risk and the extent to which the fund modelled out and was prepared for any recession or market downturn scenarios.

Reporting Requirements

- Many private funds are required to deliver their annual reports, including audited financial statements, to investors within 90 days of their fiscal year-end. Fund sponsors that need more time to prepare their annual reports should review the governing documents of their funds to determine whether they have any flexibility in this regard. In addition, if an annual report has already been prepared but has not yet been delivered to investors, managers should consider updating the report to address the COVID-19 pandemic, the potential impacts of the pandemic on the fund and its portfolio and the actions that the fund sponsor has taken and/or plans to take in light of the pandemic. See Temporary Relief from Regulatory Filings below in regard to reporting obligations under securities laws.

Side Letter Obligations

- Some funds are subject to side letters, whose provisions range from additional reporting obligations to covenants relating to environmental, social and governance issues, and to the obligation to notify the investor upon the occurrence of certain events. It would be prudent for managers to review their side letter obligations to determine whether they have any reporting or notification requirements to their investors as a result of the COVID-19 pandemic. Registered fund managers should consider their obligations to all clients in providing additional information to certain investors in relation to the impact of the COVID-19 pandemic on its portfolio. Ideally, managers should develop additional reporting to be provided to all fund investors.

Operational Matters

Liquidity and Contractual Arrangements

- **Liquidity.** Managers should critically assess the liquidity requirements of their funds and develop a plan for assessing and meeting liquidity needs.

- **Derivatives and Brokerage Arrangements.** ISDA and other master agreements and brokerage arrangements should be reviewed to assess the potential uses of such arrangements to ensure no defaults or termination events have occurred and to ensure continued compliance. Counterparties should be engaged to address any compliance issues.
- **Margin and Credit Facilities.** Managers of funds with margin and credit facilities should consider reviewing the terms of those facilities to ensure compliance and make certain that they understand the use to which they can put advances and the conditions to, and the timing for, any drawdowns under those facilities.

Approach to Transactions, Investments and Deal-Making

- **Due Diligence.** Fund sponsors should revise their due diligence procedures to address the manner in which potential investments may be affected by COVID-19 and the potential for a recession.
- **Key Deal Terms.** If a fund is entering into or terminating a transaction or investment, the manager should consider key deal terms, including conditions to closing, the material adverse change (MAC) clause, representations and warranties and pre-closing covenants. "Tried and true" precedents and "market" deal terms may need to be adjusted and should be re-evaluated keeping in mind current market conditions and the particular circumstances of the company involved in the transaction. For more information about MAC clauses, see our bulletin COVID-19: Material Adverse Change and Material Adverse Effect.
- **Pending Transaction.** Managers may wish to review the pre-closing covenants and conditions applicable to any pending transactions to determine whether they and the counterparty are capable of complying with them.
- **Distressed Investing.** Current market conditions may result in opportunities to invest in distressed assets. Fund managers should review the governing agreements and private placement memoranda of their funds to determine whether the fund has the capability to make those types of investments, given the investment objectives and strategies of the funds and the disclosure that was provided to investors. In addition, side letters should be reviewed for similar restrictions and related notice requirements.

Temporary Relief from Regulatory Filings

- **Relief from Certain Canadian Securities Filings.** Canadian registrants will benefit from blanket relief originally announced by the Canadian Securities Administrators (CSA) on March 20, 2020. The Ontario order and similar orders issued in other Canadian jurisdictions on March 23 provide that the due dates for registered dealers, registered advisers and registered investment fund managers to deliver certain financial statements and excess working capital calculations are extended by up to 45 days when the delivery deadlines fall between March 23, 2020, and June 1, 2020. The Ontario order further provides that the due dates for registered firms and unregistered capital markets participants to satisfy certain fee-related requirements in connection with the payment of participation fees are also extended by up to 45 days when the delivery deadlines fall between March 23, 2020, and June 1, 2020.
- **Relief from U.S. Investment Advisers Act Filing Obligations.** Private fund managers that are registered advisers or exempt reporting advisers with the U.S. Securities and Exchange Commission (SEC) may benefit from temporary relief from the obligation to file an amendment to their Form ADVs on the regularly scheduled filing date if they comply with an order that was granted by the SEC on March 13, 2020. Registered advisers and exempt reporting advisers that are unable to meet the filing deadline due to circumstances related to current or potential effects of COVID-19 will benefit from this relief if they promptly notify the SEC by email and disclose on their public websites (or if they do not have a public website, promptly notify their clients and/or private fund investors of) (i) the fact that they are relying on the SEC's order; (ii) a brief description of the reasons why they could not file or deliver the amendment on a timely basis; and (iii) the estimated date by which they expect to file the amendment. The SEC's order applies to amendments to Form ADVs that are due between (and including) March 13, 2020, and April 30, 2020. Registered advisers and exempt reporting advisers who rely on the SEC's order are required to file the amendment within 45 days of the original due date. For more information about the SEC's order, see our bulletin SEC Provides Temporary Relief for Filers Affected by COVID-19.

Valuations and Asset Pricing

- Consider how valuation agents and other pricing services have been performing, particularly with respect to hard-to-value asset classes and/or asset classes for which reported prices appear to be unreliable.
- Continue to apply the valuation principles that apply to the fund, including with respect to private debt, private companies and other assets that do not have readily available market pricing.

Redemptions

- Managers receiving redemption requests that could potentially trigger gates or raise liquidity issues need to consider their obligations to both redeeming and remaining investors. Consideration should be given to the short- and long-term implications of imposing gates. For any fund that was structured without formal gates, suspending redemptions should nevertheless be considered if there are material risks that the manager's obligations to all of its investors cannot otherwise be met.

Considerations for Fund Launches and Continued Marketing

Disclosure

- Any managers that are actively marketing a fund should review the disclosure in their private placement memorandum to determine whether the risks associated with pandemics such as COVID-19 and the potential implications to the fund and its portfolio are adequately disclosed. In addition, if any performance information included in the private placement memorandum is expected to change in any material respect, the manager should consider including additional disclosure to that effect. Under Canadian securities laws, investors have statutory rights of rescission and statutory rights of action for damages if an offering memorandum contains any misrepresentation, whose definition includes the omission to state a material fact that is necessary to make a statement not misleading in light of the circumstances in which it was made.

Key Fund Terms

- Given the uncertainty associated with the COVID-19 pandemic, managers that are currently launching or marketing a fund should consider whether to adjust key fund terms such as the following:
  - **Investment Restrictions.** Managers should consider whether to include additional flexibility in the fund's investment strategies to accommodate distressed and opportunistic investments generally or upon the occurrence of certain events.
  - **Economics.** It is too early to tell how and to what extent the COVID-19 pandemic will affect fund economics, if at all. However, fund managers that have not yet launched their funds may wish to consider the key economic terms of their funds in view of the current environment.
  - **Fund Expenses**. In light of the CSA's view that reimbursable fund expenses must be expressly disclosed, fund managers should consider if there may be additional valuation, administrative or regulatory expenses that should be disclosed.
  - **Reporting Obligations and Investor Meetings.** Managers should consider providing for flexible timelines for the fund's obligation to deliver quarterly and annual reports and net asset value statements.
  - **Redemption Gates.** As was observed in the months immediately following the 2008 financial crisis, redemption gates can operate as effective safety valves that limit the impact of increased redemptions on the value, liquidity and concentration of a fund's portfolio. When designing a gate, fund managers should carefully consider the appropriate gating trigger in light of the liquidity of the fund's portfolio, the concentration of investors and other factors. Managers may wish to consider choosing one or a combination of investor level gates, a fund level gate and redemption fees.

To see our insights on how COVID-19 may affect closed-end fund managers, see COVID-19: What Private Fund Managers Need to Know Now.

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