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Redemptions

Stigma Fades as Use of Gates Becomes More Common

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By Christopher Faille, *Hedge Fund Law Report*

A "gate" is a contractual provision, found in the governing documents of most hedge funds, providing that if redemption requests on a certain date exceed a certain percentage of the fund's net assets (typically, 10% to 20%), then the fund manager can limit redemptions on that date to a certain percentage of the fund's net assets and carry forward the balance of the redemption requests to the next scheduled redemption date.

Under typical gate provisions, if at the next scheduled redemption date the redemption requests (new as well as carried-forward) again exceed the threshold, the manager may again exercise the gate with respect to that subsequent redemption date.

Gates are one among various categories of tools available to stanch the outflow of investor money in times of stress. Other tools include blanket suspensions of redemptions and side pockets (separate accounts that, in a nutshell, enable a manager to defer valuation or liquidation of certain illiquid assets).

Since the onset of the credit crisis, the imposition of gates limiting redemptions from hedge funds has become increasingly common. However, there was a time, not too long ago, when the lowering of a gate was a hedge fund industry taboo – a sign of imminent and irrevocable decline. For example, in September 2006, after hedge fund manager Amaranth Advisors LLC announced major losses on natural gas futures trades, there was speculation about whether Amaranth could survive by exercise of its gates – but the idea met with an incredulous response. Jay Gould, a hedge fund lawyer with Pillsbury Winthrop Shaw Pittman, told a Reuters reporter at the time, "[t]he idea that they would stand by their documents and make investors wait years is not an informed business strategy."

The Bygone Stigma

A week after Gould gave that interview, Amaranth sent a letter to its investors announcing that it would not invoke the gate, but rather would suspend redemptions for the redemption dates of September 30 and October 31. Soon thereafter, Amaranth began a liquidation of its funds in which investors recovered pennies on the dollars.

The reluctance of the Amaranth principals to lower the gate, even in extenuating circumstances, illustrates the strength of the old stigma. But that stigma has not been in evidence of late. Gregory Nowak, a partner at the Philadelphia office of Pepper Hamilton, LLP, said in an interview, "these are exceptional times, when General Motors has to go to Congress hat-in-hand,

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or when a blue-chip company like Citigroup sees such an extraordinary drop in its value." In such times, hedge fund managers are increasingly amenable to techniques for retaining assets and avoiding asset sales at distressed prices.

In a December 3, 2008 regulatory filing, Fortress Investment Group LLC, the publicly-traded alternative asset manager, stated that it had lowered the gate on investors in its flagship Drawbridge Global Macro Fund. Fortress informed investors that it has received notices of redemption for both the November 30 and the December 31 redemption dates for a total of approximately $3.51 billion (including $1.5 billion previously disclosed).

The filing added: "Taking into account the redemption notices received, the suspension of those redemptions and the anticipated restructuring of the funds, the Company estimates that the Funds' [assets under management] as of January 1, 2009 will be approximately $3.65 billion."

And Fortress is not alone. Ore Hill Partners, Drake Capital Management, Tisbury Capital Management and Pardus Capital Management all have exercised gates in 2008. According to some accounts, more than 80 hedge fund managers have limited or suspended redemptions from some or all of their funds over the last two months alone.

The Balancing Act

One primary goal of gates is to protect the interests of all investors over the interests of a particular subset of investors. "It's always a balancing act," said Mr. Nowak. "The exercise of a gate can be hard on the party that wanted to redeem, but in the long run it allows all investors to be treated fairly."

Another key rationale for including a gate provision in a fund's governing documents, and for triggering the gate, is to match the liquidity of fund interests with the liquidity of the assets in the fund's portfolio. Accordingly, a gate makes more sense when the fund is invested in illiquid or less liquid assets – items such as bank loans, swaps or shares in privately held companies.

Hector Sants, the head of United Kingdom's Financial Services Authority, highlighted this point in a speech to a meeting of hedge fund managers on October 22, 2008.

"Some managers have learnt the hard way that the ability to deal efficiently with investor redemptions relies on proper alignment of fund liquidity with that of the underlying assets," he said. "Additionally, gate structures that may have been established several years ago may need to be reviewed in order to avoid generating additional redemptions from otherwise satisfied investors taking steps to avoid being 'at the back of the queue.'"

Mr. Sants' reference to winding up "at the back of the queue" alludes to the strategic behavior often associated with redemption requests in the presence of gate provisions. Of late, many investors in hedge funds with gate provisions have been submitting "preemptive" redemption notices to ensure their priority in the event of the imposition of a gate, with the intention of withdrawing those redemption requests if the gate is not imposed. Among other consequences, such preemptive requests create the sense of a heavy volume of redemptions in the offing, which in turn can cause managers to sell assets at inopportune times and to impose gates – when such managers, in possession of a more realistic assessment of redemption amounts, would not have sold such assets or imposed the gate. The strategic behavior, in this sense, can be a self-fulfilling prophesy. See also "Gates Provide Safety Valves for Hedge Funds and Investors," Hedge Fund Law Report, Vol. 1, No. 7 (Apr. 15, 2008).

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As for how to counter such behavior, one route would be to make redemption requests irrevocable – which, in this environment of heavy redemptions, would be hard to effectuate in a credible manner. Another would be to eliminate or revise the terms of the gate. Steven Huttler, of counsel at Sadis & Goldberg LLP, said in an interview that hedge fund managers are sensitive to the "prisoners' dilemma" that gates can engender. "A hedge fund client recently contacted me and wanted to change the gate provision in his fund documentation," he recalled. "He told me he didn't want to encourage a race to the exits."

Declines in Net Asset Value

A consideration related to gates are provisions in prime brokerage agreements and many swap agreements on the ISDA form providing that a decline of a certain percentage of a fund's net asset value constitutes an event of default, giving the lender the right to call in the loan or the swap counterparty the right to terminate. As Mr. Huttler pointed out, for hedge funds dealing with investment banks – as prime brokers or ISDA counterparties – such provisions are among "the first that you'll want to fight about."

Similarly, Irwin Latner, a partner at Herrick Feinstein LLP, noted that "[s]ome of our clients have already started to negotiate ways in which the termination events due to net asset value declines can be triggered only by negative performance, not simply by investor withdrawals."

"Surgical" Approaches to Limiting Redemptions

Mr. Latner also noted that to manage a hedge fund's liquidity in times of market stress may require more "surgical" approaches than simply imposing or not imposing a gate. "Otherwise," he warned, managers may "head down the path to repeating all the mistakes of the present when the next credit crunch or market disruption occurs." By way of example of such a surgical measure, he suggested that a fund's governing documents might give the manager a discretionary right to refuse to meet redemptions by selling assets into a distressed market at prices that, in the manager's view, do not reflect fair value.

"This would be analogous to a lock-up, but more flexible, and not quite the fire-alarm we're seeing in the market today."

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