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Redemptions

Six Criteria for Hedge Fund Managers to Evaluate Before Granting an Investor's Request to Rescind Its Redemption (Part One of Two)

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The beginning of the fourth quarter often leaves hedge fund managers bracing for year-end redemptions. Although withdrawal schedules differ across funds, December 31 is often a critical date for hedge funds, as it is relevant to funds that permit redemptions on a monthly, quarterly or annual basis. Notice periods vary as well, but studies indicate that 45- or 60-day notice periods are the most common, by far. See "Study Charts Rise of Non-Equity Funds and Related Founder Share Classes" (Apr. 19, 2018).

The investor relations, operations and finance personnel, along with the fund's administrator, are largely responsible for managing the redemption process. There are instances, however, where in-house counsel and compliance officers are asked to weigh in on redemption-related decisions, including the case where an investor has submitted its redemption request in a timely fashion but thereafter seeks to rescind that request.[1]

Understandably, an investment manager may be happy to permit an investor to rescind its request. After all, the management fee paid to the fund manager is typically calculated as a percentage of the fund's net assets. Decisions around rescission requests, however, should not be made haphazardly or without weighing several factors, including potential conflicts of interest. Additionally, investors and regulators may take the view that investors that are permitted to rescind their redemption requests have essentially been granted different liquidity terms than the other investors, which can raise disclosure and fairness issues.

In anticipation of year-end redemptions, this two-part series explores how fund managers should evaluate rescission requests. This first article analyzes the provisions in a fund's governing documents that are relevant to those requests, investors' motivations underlying rescission requests and three considerations that fund managers should factor into their decision-making processes. The second article will outline three additional factors that fund managers should consider and explore ways fund managers should document their decision-making processes.

For more on the importance of adhering to a fund's redemption terms, see "SEC Order Reminds Advisers to Adhere to Stated Redemption Procedures" (Nov. 1, 2018).

Are Redemption Requests Irrevocable?

It is imperative when setting up a hedge fund that the "investment manager designates a redemption notice period that closely aligns with its investment strategy," explained Stroock partner Michael Emanuel. Generally speaking, the more liquid the underlying assets, the shorter the notice period that can be set by the investment manager. Even with very liquid strategies, however, fund managers need to ensure that they have sufficient time to liquidate investments in an orderly manner to meet redemption requests. Conversely, fund managers will want to avoid periods that are too long, as they may discourage some investors from committing. "Thus, getting it exactly right up front is important," he added.

A fund's offering documents will discuss in detail the steps that an investor must take to redeem from the fund. Within those disclosures, there will frequently be a provision putting the investor on notice that once a redemption request is submitted, that request is irrevocable unless otherwise permitted by the fund's general partner/board of directors, in its sole discretion.

Although fund managers are typically incentivized to keep capital in the fund – if for no other reason than they would continue to earn fixed fees on that capital – Emanuel explained that this language has become standard because fund managers need to plan in advance how to meet redemption requests, and advanced planning becomes all the more critical as the overall liquidity of the portfolio declines. The manager wants to avoid being in a situation where it has begun to liquidate assets, only to later find out that the investor would like to rescind its redemption request and remain invested in the fund, at which point the fund may be sitting on cash that the investment manager must then reinvest if the request were granted. Sidley partner Bradley Howard added that "if an investor could unilaterally rescind its redemption request, it would basically have a free option on liquidity, which is obviously problematic."

Despite language concerning the irrevocable nature of redemption requests, fund managers often view the submission of a redemption request as the starting point of negotiations with that investor to convince it to remain in the fund, noted Howard. Additionally, it is not uncommon for an investor to verbally communicate to the manager that, although it has submitted a redemption request, it may plan to rescind it at some point, Emanuel added. Once an investor submits its request to redeem, it of course runs the risk that the manager will decide not to grant a request to rescind. That outcome is less likely in today's environment, however, in which investors have the upper hand in these sorts of negotiations. Thus, "in many cases, if the investor wants to rescind its redemption request, the manager will agree if it has planned for that possibility," noted Emanuel.

Motivations Behind Rescission Requests

There are several reasons why an investor may submit a redemption request with the intent of rescinding it in the future.

Liquidity Mismatches

When an investor in a fund has underlying beneficial owners with their own liquidity needs, there may be a mismatch between the fund's liquidity and that of the beneficial owners of that investor. The classic case is a fund of funds that has a shorter notice period than a fund in which it is invested.

Emanuel offered the following example to illustrate this predicament: if the direct investment fund permits redemptions annually on 90 days' notice, but the fund of funds permits its investors to redeem annually on 60 days' notice, then the fund of funds may be forced to put in a redemption request because it does not yet know the amount of capital that its own investors will request to redeem.

Market-Driven Motivations

Additionally, investors may also be more likely to submit redemption requests that they may later seek to rescind when they want more time to monitor and react to the market. Investors are more likely to adopt this mindset during periods of market uncertainty, Emanuel suggested, when the market may shift significantly before the effective date of the redemption. By putting in a redemption request, the investor has preserved an opportunity to move its capital to less risky strategies, but should things turn around, the investor could always request to rescind that request, which request the fund manager would be under no obligation to grant.

Adam Reback, director of Optima Partners, added that, in his experience, "this wait-and-see approach seems to be more common in times when there is significant volatility in the markets and investors seek to preserve the option to get out of the fund." He added that he would also expect to see more rescission requests after the fund had started to turn things around after a period of poor performance.

Asset Control Issues

Some investors also have less control over their assets. For example, investments by foundations and endowments are often subject to the ultimate review of a board or investment committee, and those managing investments on a day-to-day basis may be unsure how the final decision makers will respond. Thus, they may feel that it is necessary to submit redemption requests to ensure that they have as much flexibility as possible.

Negotiating Tactics

Finally, an investor may use the submission of a redemption request as an opportunity to reopen the negotiation of its investment terms with the fund manager or to otherwise put the manager on notice that it is at risk of losing the opportunity to manage the investor's capital, noted Emanuel. For example, the investor may be looking to lower its fees or extract other concessions from the manager.

Factors to Consider When Deciding Whether to Grant a Rescission Request

When deciding whether to grant a rescission request, managers must evaluate "whether the rescission would be fair and equitable to all of the manager's investors," explained Reback. Put another way, Howard asked, "Would granting the rescission request be in the best interests of the fund as a whole and the remaining investors?"

These are not necessarily easy decisions for the manager to make because, in most cases, a manager would prefer to continue to earn a fixed fee, and as Howard pointed out, "managers need to keep their fees up so that they can pay their staff and operating expenses."

Thus, when weighing the pros and cons of whether to permit an investor to rescind its redemption request, a manager should consider the following factors.

1) How Would a Rescission Affect Other Investors in the Fund?

The overarching principle to which fund managers must adhere when deciding whether to permit an investor to rescind a redemption request is what outcome would be in the best interest of the portfolio and all the investors as a whole, explained Emanuel. It may very well be the case that permitting the investor to remain in the fund is a better option for all involved. For example, "assume that a manager with $150 million in assets under management receives a full redemption request from an investor asking to redeem its $15-million investment," noted Emanuel, "but thereafter that investor changes its mind and decides that it would like to stay in the fund." From the manager's perspective, it is likely in its best interest to agree to that. The rescission may also benefit the remaining investors, as investments would not have to be liquidated prematurely, and expense ratios could remain constant.

"The only problem is if the fund manager does not manage the investment side correctly," Emanuel continued. One factor to consider will be whether the manager has already liquidated assets to generate cash in preparation for meeting the redemption request, in which case the manager would presumably have to reinvest those assets should it permit the investor to remain in the fund. "That can affect the entire portfolio, not just the investor seeking to rescind," noted Emanuel.

For more liquid strategies, the investment manager can add similar-type positions. Access to those investments is not likely to be an issue, but the market could have moved up or down during that time, which would certainly be a consideration. Another aspect of the analysis is whether a tax burden was generated when the investments were sold, which in turn would affect all investors in the fund. "Managers must think through these sorts of issues and be able to conclude that the remaining investors would not be disadvantaged by this investor rescinding," he advised.

One suggestion that Emanuel offered to manage this risk is that, if a manager knows that an investor is considering rescinding its redemption request, "at some point, the manager may very well have to give the investor a deadline, past which it will not accept a request to rescind." By imposing a deadline, the manager should be able to avoid the issues of prematurely liquidating fund assets or generating unnecessary tax burdens.

2) Is This a One-Off Rescission Request Due to a Change in Circumstances?

"I find it less troubling when an investor requests to rescind its redemption request because it has changed its mind – or the underlying facts that caused the investor to submit the request in the first place have changed – and the request is made well in advance of the actual redemption date," Howard explained, adding, "If it's totally idiosyncratic and there is plenty of time before the redemption date, then keeping the money in the fund will likely be viewed as a positive, because the manager will not be forced to sell down positions or increase leverage, and expense ratios will not change." Howard also pointed out that the manager would be happy to not reduce its fee, but in this scenario, keeping the money in the fund would not be likely to harm – and in fact would likely benefit – the other investors.

Reback agreed, noting that "if it happened once and there was a valid reason behind the rescission request, it might make sense for the manager to grant that request." Compare the one-off request with a situation where the same investor routinely submits redemption requests and thereafter seeks to rescind them prior to the relevant redemption dates. In those cases, "where it appears that the investor is engaging in abusive-type behavior or otherwise seeking to game the system, I think the manager would want to put a stop to it. This kind of behavior would also likely be frowned upon by regulators and investors alike," he remarked.

3) Is the Manager Providing the Investor With Different Liquidity Terms?

"A manager should also consider whether granting these types of requests would amount to one investor or group of investors having different or preferential investment terms than the fund's other investors," explained Reback.

For example, assume that the fund's documents permit an investor to redeem from the fund as of each quarter-end on 45-days' prior written notice. Investor A submits a timely redemption notice. Fifteen days before the redemption date, however, Investor A decides that the fund's performance looks great and it would rather stay in the fund, at which point Investor A asks the manager if it may revoke its redemption request. Thereafter, the same thing happens the next quarter, and the next. "In this type of scenario, it's not exactly the same thing as giving that investor enhanced liquidity terms, but it feels like it," Reback quipped.

"If there were an investor who submitted redemption requests and then routinely yanked them as the redemption dates drew near, the investment manager would be effectively permitting that investor to have a shorter redemption notice period," Reback explained. "That's the way I would view that, because that investor now has a look-back."

Granted, most fund offering documents are drafted in a way that permits a fund's general partner or board of directors, as applicable, to waive or modify the terms or conditions relating to redemptions, which presumably would include the length of the redemption notice period. Regulators or other investors, however, will likely want to know whether the investment manager has granted different terms to one or more investors, especially when those terms relate to liquidity. Thus, managers will need to think about how permitting an investor to rescind a redemption request will affect its existing or future disclosure obligations.

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[1] For purposes of this article, unless the context otherwise requires, the term "redemption" is broadly used to refer to both withdrawals from a fund structured as a limited partnership and redemptions from a fund structured as a company.