Chapter 10

Liquidity

10.1 Introduction

Before a prospective investor commits to provide money to an alternative investment fund he will need to know how, and at what time, such money can be returned to him, ideally with an amount of additional profit based on the success of the fund.

Generally, liquidity may be provided to investors in one of two ways. An investor may elect to transfer this interest in the fund (e.g. shares, units, partnership interests) to a third party with whom he has negotiated a mutually agreeable price. Alternatively, an investor may have the right to demand at certain times the redemption of his interests in the fund in exchange for a sum derived from the net asset value of the fund at such time. The former is commonly known as a closed-ended fund and the latter as an open-ended fund.

10.1.1 Closed-ended funds

Many closed-ended funds are listed on stock exchanges, which facilitate the regular trading of the interests, enabling willing sellers to transact with willing buyers. *See* Section 1.6.4: "Investment companies". Like any market price, however, the price at which a closed-ended fund is sold will reflect the sentiments of the market (which may either overvalue or undervalue any security). Importantly, once an investor has sold his interest, the underlying assets of the fund remain unchanged.

Where a liquid secondary market has not been established for a closed-ended fund, investors would instead rely on the fund manager to return some or all of the capital of the fund, together with any profits, either at predetermined dates or at the fund manager's own discretion.

10.1.2 Open-ended funds

By providing investors with the ability to receive a return of net asset value for their interests, an open-ended fund removes the necessity of the investor to identify a buyer and negotiate a price. Further, it allows investors with different

time horizons to participate in the same fund, confident in the knowledge that they can obtain liquidity when most suitable to their own internal requirements.

The fund, however, faces the prospect of significant changes in the amount of its capital in situations where redemptions on a particular date exceed new subscriptions. Investments may need to be sold to fund redemption requests. As a result, funds either investing in illiquid assets or pursuing longer term investment strategics may find open-endedness incompatible with their objectives.

10.1.3 Unlimited vs. limited life

A fund may have either an unlimited or limited life. Generally, funds that are open-ended are established with an unlimited life, as investors know that they can obtain liquidity by way of redemption at their discretion. As a result, any proceeds from the sale of underlying investments may be reinvested in new investments.

Where a fund is closed-ended and not listed on an exchange which provides for a liquid secondary market, a limited life may be required by investors to assure them that their capital (with any profits) will be returned to them at a predetermined time (e.g. seven years). Where the underlying assets are themselves illiquid, proceeds from realisations may be required to be returned to investors in advance of the termination date.

10.2 Subscription and redemption

Open-ended funds allow for periodic subscription and/or redemption by investors throughout the life of the fund. The frequency with which a fund manager will be willing to accept further investments may be the same or different from the frequency with which it will be willing to provide an investor with their monies back. Both decisions will be driven in part by the nature and liquidity of the underlying assets and the perceived ability to identify new investments and to realise existing investments.

Where the assets are highly liquid and actively traded, subscriptions and redemptions may be possible with great regularity. Otherwise, interim liquidity may be highly restricted. In either case, redemptions may be subject to initial lock-in periods, fees charged on redemptions or limits on the amounts that may be redeemed at one time.

At such time as further subscriptions or redemptions are permitted, it will be necessary to recalculate the fund's net asset value. These calculations entail determining the current value of each of the fund's investments and allocating profits and losses to each investor. Highly liquid investments can be valued based on quoted prices on an exchange or quotation service. Less liquid investments will require more subjective analysis. *See* Section 9.4.1: "Valuation".

The ability to obtain interim liquidity from an alternative investment fund can be crucial to investor. Due to the lack of a pre-determined termination date, the investment horizon may vary significantly from one investor to another. However, periodic redemptions can, at times, pose risks to non-redeeming investors, particularly in volatile markets.

To prevent the occurrence of a "downward spiral" in a fund's net asset value caused by redemptions being made in a falling market, some funds impose a "gate" system to limit the ability of investors to take more than a predetermined percentage of the fund's assets out on any dealing date. Typically, such funds will limit withdrawals to 10–20 per cent of their assets, which inevitably causes a holding in such fund to be subject to potential illiquidity at precisely the time when an investor may most want his money back. Without such limitations, however, non-redeeming investors face the prospect of being left with a share in a rump of assets disproportionately undervalued, as in practice the most highly valued assets would be the easiest for a fund manager to sell on short notice to meet pending redemption requests.

Gate provisions differ significantly from fund to fund, with different thresholds and notice periods applying to different classes of investors. Typically, where a threshold is met, investors in a particular class can participate up to the threshold pro rata, with the balance of their redemption request postponed to the next dealing day.

Practice Point

As a result of their need for higher transparency, institutional investors will carry out more diligence both pre-investment and during the length of their investment. As a result, to make their efforts worthwhile, they will typically invest substantially more than high net worth and other investors. Consequently, a fund manager must contemplate the possibility that significant amounts of money may be redeemed at one time and the effect of this on the investment strategy.

10.3 Drawdown and harvest

10.3.1 General

Closed-ended funds do not allow periodic liquidity at the request of investors. Typical of private equity funds and real estate funds, these vehicles take investors' committed capital during the early years of a fund's life and only return proceeds to investors when the underlying investments are realised.

Funds structured as limited partnerships are frequently based on a drawdown structure, where limited partners commit to provide a certain amount of capital to

the fund at launch, but such amount is only called for by the general partner where suitable investment is identified. *See* Section 4.2.1: "Limited partnership". Where investments are illiquid and to be held for considerable time before their realisation, a drawdown structure allows a fund manager from having excess cash on hand. Such uninvested cash could negatively impact the fund's returns. *See* Section 9.3.2: "Internal rate of return".

> ***Practice Point***
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> *Pursuant to Section 4(2) of the Limited Partnership Act 1907, limited partners are required to make a contribution of capital upon their admission to the partnership, but such amount may be nominal.*

Drawdown structures can also be mimicked in corporate structures whereby classes of ordinary and preferred shares can be used to allow investors to pay in only a small sum at launch and the remainder when drawndown by the fund manager. One advantage of this structure is that, as a closed ended company, the fund would fall outside the definition of "collective investment schemes" under FSMA and, consequently, enjoy potentially greater distribution. *See* Section 7.7: "Non-CIS investment entities".

10.3.2 Drawdowns

Drawdown notices sent to investors will require that some or all of the capital that they are obliged to provide must be paid within a prescribed period (e.g. ten business days). Failure to comply with the notice by an investor would prevent a fund from being able to complete a proposed investment.

An investor's capital commitment to a fund typically lasts until the end of the prescribed investment period, which will be the first few years of a fund's life. Commitments not drawn down during this period will be waived by the fund except for a certain amount which will be available for further investment in current fund assets.

As a general rule, once capital has been drawn by a fund and invested, when that investment is realised, the proceeds must be returned to the investors. Typically, this is the only liquidity option that investors in a drawdown structure possess. Exceptions may be made for investments that are realised in a very short time (e.g. one year).

In the drawdown model, commitments of investors can be called by a fund manager when an investment opportunity has been identified. The risk that one or more investors will fail to provide their monies when required is ever present, although

focus on this risk has increased in the very recent past as disputes between investors and fund managers have led to threats of default and retaliation. *See* Section 9.6: "Rights of investors".

By their terms, the constituent documents of such funds (e.g. limited partnership agreements) impose stringent penalties on investors who default. A defaulting investor may either see his interest in the fund forfeited or sold to other investors or third parties. Such provisions are not frequently invoked, but rather serve as the backdrop against which investor liquidity difficulties or disputes with fund managers may be resolved. *See* Section 9.8: "Dispute resolution mechanisms".

Whether a fund manager chooses to exercise their full scope of rights is a separate question. Rather than risk open disputes, and the possibility of litigation, many fund managers are preferring to reduce capital commitments voluntarily. This provides for a solution across the fund, rather than on an investor-by-investor basis.

Due to the lack of real liquidity for unfunded capital commitments, disputes cannot always be avoided by means of selling out some or all of a participation. In a particularly difficult market or where a fund manager has lost the "faith" of his investors for all intents and purposes the fund can revert to a "pledge fund" where investors can pick and close the investments that they wish to participate in.

10.3.3 Recall of capital

A question closely associated with the use of limited partnerships as fund vehicles is under what circumstance can capital returned by a partnership to a limited partnership be recalled to meet liabilities to third parties? *See* Section 4.2.1: "Limited partnership". The positions under UK and US law differ significantly leading to different structural approaches.

In the United States, a limited partner is not liable to recontribute capital returned to him. However, pursuant to the terms of a partnership agreement such an obligation may be imposed. Typically such obligations cover only the payment of fund expenses.

In the United Kingdom, pursuant to Section 4(3) Limited Partnership Act 1907, any such returned capital would need to be contributed to cover any debts of the partnership. This treatment of returned capital has led to the establishment in the UK of partnerships based on a very small sum of capital, with the remaining commitment provided as a loan advance. Such loan advances are then repaid by the partnership as investments are harvested. The ratio of loan advance to capital can be 99.9 to 1, or lower. *See* Section 3.3.3: "US and UK approaches".

10.3.4 Distributions

The constituent documents of a fund (e.g. partnership agreement) will provide for the manner in which distribution will be made to investors. These provisions are often referred as the "waterfall", due to the fact that monies received from realised investments flow down the list of recipients who participate in different ratios at different levels.

Typically, the timing of such distribution will be at the discretion of the fund manager. However, following the realisation of an investment, a specified time limit will usually be imposed before which time the proceeds of such realisation will need to be distributed. Amounts may be retained to cover expenses of the fund and the fund manager, as agreed.

Distributions will generally be made in cash. However, provision may be included for distribution of certain assets "in specie". One example of where this is done is in the context of venture capital fund, where listed shares may be distributed to investors rather than the cash proceed obtained on their sale. *See* Section 10.4: "In-kind distributions".

The function of the waterfall is to establish how profits from investments will be divided between the investors and the fund manager once an investment is harvested. It is by way of the waterfall that the fund manager and its principals receive their carried interest.

The first step will be a repayment to the investors of the capital that they have provided to the fund. A preferred return (e.g. 8 per cent) may be required to be paid to investors as well. *See* Section 11.3.7: "Preferred returns".

At this point, a fund manager would expect to begin earning his carried interest. *See* Section 11.3: "Performance fees". A question arises, though, with regard to the preferred return whether or not a fund manager should earn a carry of this initial level of performance. Where the answer is "yes", a catch-up provision will be included whereby the fund manager will receive some or all of the profits thereafter until the amount equal to a carry on the preferred return has been passed. Thereafter, all profits will be divided between the investors and the fund manager in line with the carried interest (e.g. 80:20). Where the answer is "no", the ability of a fund manager to receive any earned interest is not only predicated on outperforming the preferred return but significantly less than in the alternative.

10.3.5 Carve outs

Carve outs may be established for distributions of cash not directly attributable to investments. In these circumstances no carried interest would be payable to the fund manager. An example of such payment would be the distribution of interest on money held by the fund prior to investment or after realisation.

Another carve out is frequently made for tax distributions. Under certain circumstances, a partner could become liable for tax on profits of the partnership (due to its transparency) for when he has not received any cash distribution. Tax distributions are meant to ensure that any such liabilities are not unfunded. *See* Chapter 12: "Taxation Principles and Concepts".

10.3.6 Investor giveback

The obligation of investors to return distributed money back to the fund has become increasingly accepted in the US, although practice is more diverse in the UK and Europe.

The basis for this obligation is that the possibility exists for liabilities to arise (e.g. indemnities) to the fund which, in the absence of sufficient assets could fall to the general partner where the fund is structured as a partnership. *See* Section 4.2.1: "Limited partnership". Many general partners view this as the quid pro quo for their own obligations under the clawback provisions. *See* Section 11.3.3: "Clawback". The focus of negotiations frequently centres upon:

(a) time limits; and
(b) caps on the amount to be returned.

> ***Practice Point***
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> *It is important to distinguish a clawback of carried interest payment by the fund of its fund manager (the so-called "GP clawback") which is based upon contractual provisions of the fund's constituent documents (e.g. partnership agreement) from a clawback by creditors of a partnership of capital returned to a limited partner during the life of the partnership (the so-called "LP giveback") which is based on underlying law but may be expanded in the partnership agreement.*

Mechanisms may also be implemented to protect the carried interest entitlement of the fund manager from loss incurred by the fund, after significant distributions had been made out of the fund. Without such mechanisms, the fund manager, as general partner, would be wholly liable for such losses, with the investors enjoying limited recourse because of their position as limited partners. Such losses could arise in a number of circumstances, including breach of warranty by the fund in the sale of an investment, or an environmental liability stemming from a non-banking investment, and could otherwise have a highly punitive effect on the fund manager.

All partner giveback provisions attempt to put the fund manager and the investors back in the same position as if the amount of the losses had never been

distributed. Such provisions remain highly contested and resisted by certain limited partners, although they are becoming more common in fund documentation, albeit subject to predetermined percentage and/or "sunset" limitations.

10.3.7 Other approaches

Where interim liquidity is not provided to investors by the fund, interest in such closed-ended funds can be illiquid and trade only at significant discounts, if at all. Interim liquidity can be achieved either through secondary transactions in the fund interest or through the securitisation of a number of such interests. Despite the growth of dedicated secondary players over the past decade, concern is frequently expressed by investors over the significant discounts demanded by such buyers. *See* Section 4.8: "Secondary funds". As a result, many look at recent developments in securitisation as a means to provide fuller pricing and install more completion to this market. *See* Section 4.7: "Structured products".

Securitisation provides a means to issue notes (senior AAA-rated and tiers of more risky securities) to investors fitting their particular risk profiles. Principal protection features may also be used. Notable successes have been seen especially in the ability to sell the senior tranches, although the high fixed costs in these transactions means this approach favours only the largest portfolios of fund interests.

Secondary funds, which purchase an investor's interest in illiquid private equity funds, generally seek to buy "good assets cheaply" from sellers forced by circumstance to sell assets that they would otherwise prefer to hold. As a result, secondary funds are not typically seen by the fund's managers as a potential threat. Frequently, because of the deep discount that a secondary fund obtained when buying into the fund, a secondary fund can be viewed as one less potential dissenter over management fees or committed capital. They should be distinguished, however, from a small but growing number of firms being established to acquire or replace existing fund managers unable to turn around and realise their fund's portfolio of investments. *See* Section 9.6.2: "Removal of fund manager".

Secondary funds generally prefer to acquire fully funded interests, where the underlying portfolio investments can be diligenced and valued. Fund interests with undrawn capital commitments are riskier and often less interesting, requiring not only an evaluation of the underlying investments currently held by the fund, but also a view being taken on the abilities and prospects of the fund manager to identify further successful investment.

> ***Practice Point***
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> *In the current market environment, secondary players have the opportunity to create a more diversified portfolio of private equity fund interests than has been the case in preceding years, due to pressures on investors to achieve liquidity or rebalance investors. As a result, fund managers face potential competition for commitments to their new funds not only from other new funds of the same vintage being raised concurrently by other managers, but also from their own earlier funds which may be trading in the secondary market.*

Even where a willing buyer has agreed a transaction with a willing seller, consent of the fund manager is generally required. An analysis that the buyer's participation in the fund will not detrimentally affect the regulatory and tax treatment of the fund and its other participants is also recommended.

10.4 In-kind distributions

Where a fund reserves the right to provide its investors with in-kind distributions of securities in lieu of cash on a full or partial redemption of their interest, a number of issues arise. Typically, this occurs where the securities are not themselves freely tradable. As a result, their value is inherently problematic as there is not a liquid market for setting price. *See* Section 9.4.1: "Valuation".

> ***Practice Point***
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> *Where a hedge fund has invested in particularly liquid investments and will hold such positions across dealing days on which investors may elect to redeem, in order to protect the remaining investors in the fund, "side pockets" may be created to hold the investment. These "side pockets" operate in many ways like a private equity fund, although with considerably fewer investor protections.*

10.5 Termination

In addition to a pre-determined termination date where the fund has a fixed life, investors and fund managers must give particular thought to further termination and suspension mechanisms in cases where periodic liquidity is not available. Upon a supermajority vote of investors, many funds allow for either a "no fault"

termination of the fund or a "no fault" suspension of further investment by the fund, thereby prematurely ending either the life of the fund or the investment period. *See* Section 9.6: "Rights of investors".

Instances may arise where the investors may wish to consider continuing the fund but terminating the fund manager, either for cause or without cause. *See* Section 9.6.2: "Removal of fund manager". Any removal of a fund manager will raise questions about vesting of rights to carry for investments already made. *See* Section 11.3: "Performance fees".