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COVID 19: Liquidity Management Tools

Introduction

With COVID 19 causing significant market turmoil and sleepless nights for both fund managers and investors alike, fund management companies globally are considering measures which they can invoke in order to manage the liquidity of funds under management in the best interests of both remaining and redeeming investors.

What follows is an overview of some of the liquidity management tools which fund management companies ("**Management Companies**")[1] may want to consider in these unprecedented market conditions. The usefulness of such tools will depend on a number of different factors including the regulatory status of the fund and the profile of its investor base.

However, first we outline some general principles which should be borne in mind by Management Companies when implementing liquidity management tools.

(i) A liquidity tool will generally only be available to the Management Company where the power to use same is expressly provided for in the fund's constitutional documents and disclosed in the fund's prospectus;

(ii) Management Companies are required under both the UCITS and AIFMD framework to ensure that they treat all investors fairly, even in times of stressed market conditions. Under the UCITS framework, Management Companies must refrain from placing the interests of any group of unit-holders above the interests of any other group of unit-holders. Under the AIFMD framework, any preferential treatment accorded by an AIFM to one or more investors cannot be to the material disadvantage

[1] References to "Management Companies" in this briefing should be construed as including self-managed UCITS investment companies and internally managed AIFs where the context so requires.

of other investors. In complying with these requirements, Management Companies may need to consider adopting a slicing approach in order to mitigate against any "first-mover advantage" whereby the fund manager sells a slice of underlying assets across all liquidity profiles in order to meet "early" redemption requests instead of selling all of the most liquid assets to meet these "early" redemption requests as to do so may result in remaining investors being materially disadvantaged as a result of holding a portfolio of less-liquid assets;

(iii) Where possible, dialogue with investors can help Management Companies to manage liquidity risk, particularly in the case of large investors whose redemptions could significantly affect the ability of the fund to meet redemption requests received. In the case of retail funds where the fund is typically sold via distributor, information on likely future redemptions may be unavailable to the Management Company. However in the case of non-retail funds which are sold to institutional investors, engaging with such investors to determine their future plans will help the Management Company to determine how best to manage liquidity;

(iv) The fund must continue to comply with its stated investment policy and investment restrictions disclosed in the prospectus notwithstanding any liquidity issues arising in the portfolio;

(v) In each case, the board of directors of the relevant fund and the board of directors of the Management Company should consider and approve any course of action proposed with the reasons for their decisions being clearly documented;

(vi) The usefulness of such tools will depend on a number of different factors including the regulatory status of the fund and the profile of its investor base; and

(vii) In certain circumstances, prior engagement with the Central Bank before invoking certain of these tools may be required.

Application of Redemption Gates

Redemption gates are typically used by Management Companies in order to slow down the rate of redemptions and to allow assets to be realised in a more orderly and controlled manner than might be the case if the fund were required to meet all redemption requests as and when received. In the case of Irish retail funds and open-ended QIAIF, redemption gates can only be imposed where certain redemption thresholds have been reached. By way of example only, an Irish UCITS or retail AIF can only gate redemptions once redemption requests received on any one dealing day amount to 10% or more of the net asset value of the relevant fund or the total number of shares in the relevant fund. However open-ended QIAIF with limited liquidity can apply redemption gates at their entire discretion (subject to the terms of their constitutional document and prospectus). In applying redemption gates, Irish UCITS funds are required to reduce redemption requests pro-rata and unsatisfied redemption requests must be dealt with as if received on each subsequent dealing day until all the units to which the original request related. It is also worth noting that the Central Bank has indicated that in the case of UCITS funds, such gated investors should not be treated in priority to other redeeming investors on subsequent dealing days.[2][3]

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[2] https://centralbank.ie/docs/default-source/publications/consultation-papers/cp77/150929_cp77-feedback-statement-final_dl.pdf?sfvrsn=4

[3] Constitutional document and prospectus should be referred to in order to determine how such gated redemption requests should be treated on subsequent dealing days

Because of the fact that redemption gates restrict the investor's ability to access their redemption monies, managing reputational risk will be a key consideration for Management Companies who decide to invoke this measure.

Temporary Suspension of Redemptions

Perhaps the most draconian of emergency liquidity management tools and carrying arguably significant reputational risk, a temporary suspension of redemptions in a fund can nonetheless be an effective way in which to stop any potential "run" of redemptions on a fund and to avoid having to accept heavily discounted values for the assets held within the portfolio, which in each case is likely to damage the interests of investors. This tool can allow portfolio managers to manage redemptions in an orderly manner and obtain a better price for underlying assets once pricing conditions stabilise or improve.

This tool, which prevents investors from selling their shares and realising their investment for the duration of the suspension, should only be used in exceptional cases where the circumstances so require and the suspension is justified having regard to the interests of all shareholders. A temporary suspension of redemptions can only be invoked in the specific circumstances set down in the constitutional document and prospectus of the relevant fund.

Investors, the Central Bank and any stock exchange on which the shares of the fund are listed will need to be notified of any intention to suspend redemptions. In addition, in the case of UCITS funds, the Central Bank requires that they be notified on a periodic basis during the life of the suspension and on the lifting of the suspension.

Finally it is worth noting that the Central Bank has the power under both UCITS and AIFMD rules to require a fund to suspend redemptions in the interests of the investors or the public[4].

In-Specie Redemptions

In-specie (or "in-kind") redemptions may also be used in order to manage the liquidity of an investment fund. This involves the fund satisfying a redemption request through the transfer of an underlying asset to a redeeming investor and avoids the need to sell the underlying assets or deplete cash reserves. The depositary of an Irish domiciled fund must approve the asset allocation in order to ensure that the remaining investors are not disadvantaged by the transfer of the relevant asset to the redeeming investor(s). There are a number of regulatory rules which must be complied with where a Management Company seeks to invoke this tool:

(i) Under Irish rules, investment funds cannot force a client to accept an in-specie redemption save where that investor is looking to redeem 5% or more of the net asset value of the relevant fund. In all other cases, the fund must obtain the consent of the relevant redeeming investor;

[4] Regulation 104(2)(b) of the UCITS Regulations and Regulation 46(8)(c) of the AIFM Regulations respectively.

(ii) Irish domiciled funds are required to sell the relevant asset if so instructed by the redeeming investor. Where an investor exercises its right of sale, this tool may not necessarily be effective in a market where the liquidity of certain asset classes may have dried up;

(iii) Given operational considerations involved with the in-kind transfer of an asset from one party to another, in-specie redemptions are likely only to be suitable to meet redemption requests received from larger "institutional" clients and will not be suitable for satisfying redemption requests from retail investors; and

(iv) The redeeming investor would also need to consider the tax implications of receiving an asset from the relevant fund. In addition, where the fund is an Irish real estate fund ("**IREF**") or is not an IREF but has Irish resident investors, a thorough review of the tax implications for the relevant fund would also need to be undertaken.

Side Pockets

While not permitted in the case of UCITS funds, another viable liquidity management tool available to Irish domiciled AIF funds (where expressly provided for in the fund documentation) is the use of side pockets. This involves the creation of side pocket share classes into which assets which become illiquid or difficult to value after acquisition may be placed in return for which the investor receives shares in that side pocket class, thus avoiding the need to redeem less liquid assets at heavily discounted prices in order to meet redemption requests[5]. While the remainder of an investor's shareholding can be redeemed in the normal manner as described in the fund's documentation, shares in the side pocket class cannot be redeemed until such time as the underlying assets become sufficiently liquid. While theoretically it is possible for such side pocket share classes to accrue management fees, typically such fees are not charged until such time as the assets attributable to that side pocket class begin to be liquidated. Investors who subscribe for shares in the fund after the side pocket class has been created cannot hold shares in that class. Certain confirmations must be provided by the AIF and its depositary to the Central Bank prior to side-pockets being established and all shareholders will also need to be informed.

Again given that this tool restricts the ability of an investor to realise their investment, the use of side-pockets also carry certain reputational risk.

Application of Anti-Dilution Levy or Redemption Fees

Where permitted by the fund's documentation, it may be possible to apply an anti-dilution levy whereby the costs of realising assets to fund redemption payments are borne by the redeeming investors only, thus insulating the investors who remain invested in the fund from the negative impact which can be caused by large redemptions. The application of an anti-dilution levy may remove a potential incentive for investors to redeem and seek to benefit from "first mover advantage". Where the fund documentation does not contemplate the application of an anti-dilution levy, it is worth checking whether it does provide for the use of other anti-dilution measures such as the use of swing pricing which may be invoked with the same objective.

[5] It is worth noting that only open-ended QIAIF with limited liquidity and closed ended QIAIFs can side pocket assets which are illiquid when purchased.

Separately a fund may seek to apply a redemption fee where so permitted under the fund documentation in order to cover costs associated with liquidating assets on foot of redemption requests. This fee is typically charged as a percentage of the net asset value of the shares being redeemed and is payable directly to the fund.

In each case, the justification for charging an anti-dilution levy or redemption fee should be considered carefully and documented by the board of directors of the relevant fund and should demonstrate that the application of these measures is in the interests of investors in the fund.

Borrowing Arrangements

Another liquidity management tool which may be relied upon by funds is the use of borrowing arrangements in order to fund redemptions. However these may be of limited use in the case of large-scale redemptions depending on the regulatory status of the relevant fund. By way of example only, a UCITS fund can only borrow on a temporary basis and cannot exceed 10% of its net asset value and a retail AIF is restricted from borrowing in excess of 25% of its net asset value. Non-retail AIF may be able to avail of more comprehensive borrowing facilities as a method of managing liquidity.

Conclusion

While there are a wide range of liquidity management tools which may be available to manage liquidity in these unprecedented market conditions, it is worth noting that in its Dear CEO letter issued to all Management Companies in August 2019, the Central Bank noted that the "*deployment of liquidity management tools such as duties & charges, gates and suspensions should be done in a transparent and proportionate manner, taking into account the best interests of investors*". This should be borne in mind by all Management Companies when seeking to employ liquidity tools at their disposal within their funds under management.

Should you require any further information or assistance, please do not hesitate to contact your usual Dillon Eustace contact.

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