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Governance amidst disruption - crisis management pointers for stakeholders in uncertain economic times

The COVID-19 virus was declared a global pandemic by the World Health Organisation on 11 March 2020. Arguably not since World War II has an event put at risk, to such an all-pervasive extent, both the physical and mental well-being of everyone on the planet, as well as the way we live and do business. While fighting the health implications of COVID-19 and managing the strain on all affected nations' health services must take precedence in these unsettling times, the global economic impact on every sector of industry cannot be overstated or ignored.

This is the first in a series of posts that we will be issuing on this topic. Later in the series, we will deal with the steps to be considered in case of a significant rise in redemption/withdrawal requests from investors, issues such as how best to restructure a fund or what to do to ensure an orderly wind-down if you ultimately can't trade through (or indeed how, from an investor perspective, to protect your interests in those eventualities).

Have we been here before?

That a global recession, however sharply it hits and however long it may last, is coming, may well be a certainty. But what is not certain is that we are looking at a crisis such as the one that was faced in 2008. Clearly influenced by lessons learned, there are, on a broader level, already marked differences: the US along with most other major economies, have already rolled out the largest ever economic stimulus package in history; and while economies will likely crash, perhaps some comfort can be taken from an examination of markets where a levelling off of the impact of the virus has been experienced, such as China and South Korea. In those economies, markets are showing signs of returning to life.

While this particular challenge is unprecedented, market volatility is not. In a matter of weeks since the beginning of March, global financial markets have seen wild price fluctuations, but this has also been punctuated by periods of recovery. In terms of the US, reports indicate that significant deleveraging and de-risking processes have been instigated by many market participants to ensure cash buffers; infrastructures have not so far been failing and clearing firms, along with credit counter-parties generally, seem to be performing within expectations.

From the perspective of the funds industry, it's not guaranteed we will see the same "run on the banks" that occurred in the latter half of 2008 and during much of 2009. Indeed, one of the immediate consequences of the period after the financial crisis was a significant review and improvement of terms found in fund documents with better, clearer and more focused protections and mechanisms in place to deal with uncertain financial times.

This post contains practical advice on how to address the considerations of all relevant stakeholders in a fund structure with a view to mitigating the risks associated with redemptions/withdrawals, regulatory oversight and potential litigation.

Communication is key

To borrow a quote, for fund managers and operators, what you do in times like this, "echoes in eternity". The one issue in respect of which many commentators are in full agreement is that communication and appropriate transparency from the outset, particularly from fund managers, is key and in some cases could even be the difference between the survival or otherwise of a fund.

Investor relations

As matters have escalated globally, with a large portion of the human race finding themselves under "shelter in place'' instructions by their governments, business continuity plans must by now be fully in place. We would assume that managers and directors and other fund operators have already stress-tested and implemented these plans, including the exercise of social distancing, personnel working from home and communication with their investors as to how this crisis has or may affect their portfolios and service levels in the short to medium term. In our view, if possible, it is good practice for managers to consider offering weekly performance estimates or reports to investors. From an investor perspective, if you haven't been offered more frequent financial performance updates than you previously had, it is advisable to request these and we are seeing a trend of more and more managers willing to do this. Above all, it is key that managers demonstrate outstanding risk management procedures to their investors during these times.

Many investors will be reaching out to managers and making contact to seek reassurance as well as specialist information or reinforcement in writing of certain terms, for example, those contained in side letters or informal practices. When communicating with investors, managers and directors should be wary of the risks of over promising and under delivering. This is crucial in circumstances where there are rapidly changing market conditions.

We recommend that managers consult legal counsel at an early stage if such communications are being considered and in cases where professional or independent directors are involved in a structure, they should approve all communications. Investor relations teams should be given clear messages to provide to investors and ensure all legal requirements are being met. A simple but effective measure is to make sure that a record is kept of all conversations.

At the same time, managers should strike a balance between over-communicating and focusing their efforts on appeasement of a minority of concerned investors, on the one hand, and under-communicating by going into a defensive communication mode, on the other: this will have the effect of increasing investor nervousness. Investors should always know that their contact will be reachable by phone or email to address concerns and the same message and information must be given to all investors unless the terms offered make it clear that this may not be the case. However, in this respect caution must be exercised and if in doubt, managers and fund operators should definitely seek legal advice before giving unequal amounts or quality of information to different investors in the same fund.

That said, investors should be prepared to accept that response times may be slower; correspondence is more difficult when parties are contemplating regulatory scrutiny or even litigation down the line. Investors should expect reasonable delays for approvals and additional risk reviews for all value transfer functions. Managers and directors for their part should keep on top of communication and when in doubt over a response, should take professional advice, if necessary, and send a holding response in the meantime.

Needless to say, managers and investors alike may generally want to avoid taking advantage of the current market volatility for short-term gain. For any fund whose subscription prices are based on NAV, no shortcuts should be taken in terms of ensuring that agreed valuation principles are being followed. If appropriate, managers may want to consider protecting themselves from exposure to claims by utilising third-party valuation agents for these purposes.

While there has been some evidence of subscription activity in the market, we believe that the majority of market participants are expecting increased redemption/withdrawal activity, at least in the short to medium term. In the event that allocators/investors are considering making a redemption request, they should communicate as early as possible with their fund manager on key issues such as delays, acceptable slippage levels and other valuation issues and not seek to use redemption/withdrawal notices as a means by which to hold the fund to ransom. Communicating in advance of, as opposed to after, issuing redemption/withdrawal notices can avoid triggering disclosure clauses thereby leading to a run of redemptions by other investors

Board relations

For funds that operate with a board of directors, we would expect that the board should have already had informal discussions with the fund's manager about performance and redemptions for the end of Q1. Outside of normal informal discussions, a large number of boards may have already met in Q1 to discuss the production of financial statements. However, if one hasn't taken place recently, or at least after the crisis grew in intensity, a formal board meeting should be organised as soon as possible, whether by way of call or video-conference which can include a formal report from the manager and other service providers. Steps should be taken to ensure all necessary corporate formalities are complied with, i.e. the meeting is quorate and validly constituted and appropriate minutes are taken. Although tempting, we would recommend caution and advice be sought if intending to use video or audio recordings. Whilst not pleasant, the manager and the board of directors must also revisit the assessment of any conflicts of interest that may exist for directors or operators who are affiliated with a manager. In more extreme circumstances, consideration should also be given as to whether the manager and board of directors, respectively, need to instruct separate legal counsel.

Investors are likely to be anticipating the imposition of liquidity gates or suspensions and positioning themselves accordingly. This includes seeking to understand their rights under governing documents and side letters. Equally the operators who have overall responsibility for the governance of the fund (for example the board of directors), should, in conjunction with legal counsel, reacquaint themselves with the fund's constitutional documents and any side letters, understand their powers, know the next redemption date and know how the liquidity of the fund will be positioned on that date.

Managers and directors should work together to ensure they are prepared to meet increased redemptions and have assessed and re-assessed on a regular basis, the fund's solvency.

Service provider relations

Fund managers and directors should keep a direct line of communication open to service providers. In particular, when it comes to business continuity plans, make sure that service providers and particularly those in different jurisdictions have the same capabilities for working remotely and other procedures to minimise disruption to service levels. Reports of cyber-security breaches and scams have been widespread. Therefore the fund and every entity in its service provider network should keep on top of training and cyber-security initiatives, including continued updates of fraud risk assessment and quality control framework and ongoing scanning for new threats and risks, especially through increased use of remote working.

Regulatory relations

Regulators for the most part are working hard to assist their regulated entities, where possible and appropriate, including by offering extensions to filing deadlines and flexibility in filing mechanisms. In the Cayman Islands, the Cayman Islands Monetary Authority and the General Registrar have announced a number of specific extensions of deadlines and have emphasised that one-off extensions (for example for audited financial statement filings) will be actively considered.

Regulatory forbearance is likely to be offered for reporting deadlines and other administrative breaches, provided entities can demonstrate best efforts to comply are being utilised. Communication with regulators should be kept up to date insofar as any key board decisions are being implemented or difficulties faced which would otherwise attract regulatory scrutiny or sanction. If a suspension of redemptions or withdrawals is imposed, CIMA-registered funds must inform CIMA as soon as practicable after the decision has been taken.

Regulators have reported seeing misleading information passed around for the predominant purpose of increasing market volatility and will be highly unlikely to exercise a similar level of forbearance on enforcement for those responsible. Likewise, as noted above, there is likely to be heightened regulatory scrutiny on entities and managers accepting subscriptions; managers should ensure that any subscriptions which are accepted in volatile times are taken on fair terms, not at "fire-sale" NAV rates and they satisfy themselves (and document it) that investors understand all the risks in the specific area in which they are seeking to subscribe.

Conclusion

As leading industry expert Howard Marks of Oaktree Capital remarks in a recent memo, his favourite newspaper headline on 30 October 1929, reporting the day after the stock market crash, read "Bankers Optimistic" – which comment preceded 11 more years of the Great Depression.

Likewise, it is safe to say that no-one quite knows how severe the impending global recession will be. However, we can say that, at least so far, experiences have been different than 2008 with many funds still performing in line with Q1 expectations and many being above tracker indices, albeit with heightened requests for information and updates. The majority of funds have reported being able to conduct month-end and Q1-end NAV calculations. In contrast to 2008, major counterparties, in an effort to encourage stability, are not so far in a major rush to call in defaults. And maybe large volumes of investors will not be lining up to redeem. But if they are, lessons learnt from 2008 have taught us that suspending voluntary redemptions or NAV calculations are not the terminal step they were once considered and in fact, in certain circumstances, investors may appreciate the defensive measures when taken to protect their investments.

In our next post we will consider key issues around gating, redemptions and suspension but for the time-being we stress that these should be considered as a last case option, justified by market conditions and evaluated on the facts as opposed to fears.

For more information and key contacts please visit **harneys.com**