COVID-19: Facing a Global Challenge

KEY CONSIDERATIONS FOR FUND MANAGERS

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For more information on the legal impact of COVID-19 and for latest developments, please visit **Dechert's COVID-19 Coronavirus Business Impact Portal**

1. General Considerations for all Fund Managers

The following is a high-level summary of some general considerations for all fund and alternative asset managers.

- **Fund Documentation**
  - Risk factors and disclosures – review to ensure accuracy in the context of current situation and to determine whether some of your funds will be impacted more than others due to their investment strategy and asset allocations or as a result of how they are structured. Update to the extent necessary.
  - Financial statements – reach out to auditors, review the language in your financial statements and consider whether disclosure regarding the potential impact on valuations and the net asset value of the fund should be included.
  - Trading documentation – review the triggers in your documentation, e.g. margin calls, NAV decline triggers, key person events, etc.
  - Constitutional documentation – review to ensure that board and advisory committee meetings can take place by telephone and consider steps needed to be taken to vary the format (for example to permit virtual meetings).
  - Insurance documentation – review the terms of any insurance policies for the fund and management company that might cover COVID-19 related losses and whether any notifications are required thereunder.
- **Operational**
  - Leverage and borrowings – review and take steps as appropriate to ensure that no levels are breached.
  - Valuations – for open ended funds, consider (with auditor input) which positions may be hard to mark at month end; for closed ended funds and other less liquid funds, consider the impact the current market turmoil will have on valuations.
  - Regulatory compliance:
    - Review operational processes to ensure that you can comply with your regulatory obligations, including timely filings, and consider what steps you can take to mitigate the risk related to anticipated non-compliance.
    - Communicate with regulators if you experience or anticipate difficulties in complying with your obligations.
    - If regulators have granted forbearance, be aware of any additional conditions attached to such forbearance. Balance the need to rely on any available forbearance with the concern that doing so may expose you to future regulatory examinations especially if other managers do not take advantage of such forbearance.
    - The SEC has provided certain targeted relief to managers. See ***SEC Takes Targeted Action to Assist Funds and Advisors in Light of COVID-19 Coronavirus*** (16 March 2020).
    - Be alert to changes in regulatory requirements, such as variations in existing notification thresholds, introduction of new notifications (both long and short trading).

    - Ensure that risk management, liquidity management and valuation policies and procedures are up-to-date and appropriate to the changing circumstances. In respect of independent risk management function (whether internal or external) ensure that appropriate reporting lines are in place and that the risk management function has adequate and effective oversight of the portfolio management function. Consider AIFMD (or, if relevant, UCITS) specific requirements.

    - Review compliance monitoring programs and update as required.

- Liquidity constraints – as this crisis plays out, liquidity constraints are inevitable given the situation in liquid markets – this may lead to redemptions or difficulties funding drawdowns.

- Consider public relations with respect to business practices that otherwise constitute acceptable business practice.

Business Contingency Planning

- Review business continuity arrangements to assess their viability for the longer term rather than just the short term. In particular, take steps to ensure that all 'business as usual' systems and processes are able to cope with the new remote working arrangements – or develop new ones that are able to do so.

- Board Meetings - "virtual-only" or "hybrid" board meetings are likely to become the norm for fund boards in the immediate future. Do a sufficient number of directors remain in the jurisdiction of incorporation to maintain tax residency for the fund there? Will directors who are subject to travel lockdowns be able to dial into meetings without jeopardizing the tax position? What about execution of documents?

- Take steps to ensure that data security is not impacted. The UK's National Cyber Security Centre has a **dedicated page for asset management**, updated on 12 March 2020.

- Consider your obligations as an employer. We have prepared various updates dealing with employment aspects in different jurisdictions. For example: **COVID-19 Coronavirus – Advice for UK Employers**.

- Communicate regularly with employees to remind them of 'best practices'.

- Review service provider and counterparty operating conditions and their business continuity arrangements to assess any impact this may have on your own operations. For example, will administrators be able to provide services uninterrupted? Will counterparties be able to meet any timing deadlines (e.g. regarding valuations, investor reporting or annual audit) or will these need to be extended?

Investor Relations

- Consider increased and proactive investor outreach, particularly around performance (and sensitivity of the portfolio to COVID-19 impacts), risk management, valuations and operational matters.

- Communications with investors - usual compliance processes should apply, and given the nature of the content of these communications, they may be subject to a higher level of regulatory scrutiny than communications made in 'business as usual' circumstances. Care should be taken not to provide more favorable transparency to one investor over another which may result in a breach of a manager's regulatory obligation to treat investors fairly and not to grant preferential treatment to one investor that would materially disadvantage another investor.

- Fundraising: in the short term, how feasible is it for fundraising to continue in a zero or low-travel environment? Fundraising with new investors may be difficult, but we are seeing managers continue to close on commitments/ subscriptions from existing investors.

- **Investment opportunities**

  - Strategy shifts – where might potential investment opportunities arise and will the manager seek to pursue them? How well can opportunistic investments be accommodated within existing investment strategies? Would it make sense to seek investor approval for modified investment policies? We are seeing managers consider repurposing existing vehicles, activating their ‘contingency’ funds to pursue new opportunities, and also looking to raise new blind pool vehicles.

  - Deal-specific vehicles – for certain opportunities, deal-by-deal or co-investment structures will be more appropriate and can often be more rapidly deployed than a traditional fund. Always consult existing fund documentation to ensure pursuing a deal outside of existing funds is permissible.

  - Conflicts of interests – distress situations may create investment opportunities in a different part of the capital structure of an investee company that the manager already has exposure to. Will the manager seek to participate in such opportunities and how will conflicts be managed?

2. Liquidity Management for Open-Ended Funds

Effective liquidity management is intended to protect the fund and its investors, in particular in times of market turmoil like those currently being experienced (when assets may be less liquid, hard to value and when open-ended liquid funds are at risk of being utilized as a 'piggybank' to meet investors' cash needs).

Liquidity mechanisms can be used to prevent the sale of assets at fire sale prices and the concentration of non-redeeming/withdrawing investors in less liquid assets. Asset managers should keep their portfolio liquidity under careful review by reference to the fund's redemption and withdrawal terms and be aware of their options and obligations in the event liquidity issues arise.

The availability of any given liquidity management 'tool' discussed below will depend on a range of factors, including regulatory requirements and the terms of fund documentation. If these tools are not expressly available under fund documents, managers will need to consider whether to seek to amend documents ahead of an actual liquidity event occurring, or whether there may be some other basis for deployment.

Liquidity Management Tools

Standard Redemption/Withdrawal Terms: Frequency of redemptions/withdrawals, notice provisions, lock-up periods. Open-ended fund managers should be familiar with their standard redemption/withdrawal terms and consider the potential timing and impact of significant redemptions/withdrawals from the fund (including by reference to submitted redemption and withdrawal requests). This will inform both the ongoing constitution of the portfolio, including whether a portion of the portfolio should be moved into more liquid investments, and the imposition of further measures to deal with liquidity concerns.

Adjusting the Net Asset Value of a Fund (Anti-dilution Levy / Swing Pricing). In the event of significant redemptions from the fund and in light of potentially uncertain valuations, in order to ensure fairness between investors, the directors of the fund might determine to adjust the net asset value of the fund in order to pass on the costs of trading. This levy would typically represent a provision for market spreads (the difference between the prices at which assets are valued and/or bought or sold) and dealing costs relating to the acquisition or disposal of assets.

Gates. A gate partially limits redemptions from a fund, compared to suspensions (see below) which completely and temporarily prevent redemptions from the fund. The purpose of the gate is to avoid situations where the fund is forced to sell a significant proportion of its assets at an undervalue to the detriment of the investors as a whole. It also seeks to avoid concentration issues, whereby remaining investors are left with the fund's less liquid assets (the more liquid investments having been realised to meet the redemption requests of the redeeming investors).

A gate limits redemptions from the fund by reference to the net asset value of the fund (a fund level gate) or an investor's investment in the fund (an investor level gate).

A typical gate would prevent investors from redeeming more than 25% of the fund's net asset value on any dealing day (which, assuming quarterly dealing, would allow the fund to be fully redeemed in one year). The investor level gate works in the same way by reference to the investor's investment in the fund.

Fund level gates can have unintended consequences in times of financial turmoil. In the midst of the 2008 crisis, fund level gates were blamed for encouraging investors to submit standing redemption requests, even where they did not want to redeem from the fund (so as to avoid being the last investors left holding the fund's least liquid assets). As a result, in the years following 2008, investor level gates are often favored, given that they focus an investor's behavior on his or her own investment intentions, not those of other investors.

In the event a gate is imposed, the fund documentation should state whether deferred redemptions are treated pro-rata to new redemption requests or in priority to new redemption requests. Treating redemption requests in priority to new investment requests may also encourage a run on the fund (for the same reasons stated above).

Gates may either be elective (i.e. the directors must determine to limit the value of redemptions on any given dealing day) or mandatory (i.e. unless the directors determine otherwise the value of redemptions will be limited on any given dealing day). If a fund has an elective gate in place it is possible for the directors to make the determination now and then delegate the operation and management of the gate to the managers (who are arguably better placed to determine whether the gate should operate in the current environment). Further, for funds that deal frequently (and, as a consequence, may need to impose multiple gates), this negates the need to arrange multiple board meetings.

It should be noted that any imposition of an elective gate (or, conversely, any decision to waive a mandatory gate) should be carefully considered by reference to the impact on the redeeming investor(s) as well as the fund and non-redeeming investors.

*UCITS***.** Where applicable, considerations under UCITS should be considered. Subject to the terms of the fund documentation, Irish and Luxembourg UCITS can only impose a 'gate' where redemptions on any dealing day exceed 10% of the net asset value of the fund. If a gate is imposed, the deferred redemptions are treated pro-rata to new redemption requests. If a UCITS' redemption cycle is bimonthly, this means that the maximum amount of redemptions in any one month could be limited to 20% of the net asset value of the fund (this would be calculated on sub-fund by sub-fund basis for umbrella funds).

Side Pockets. A side pocket represents investments made by the fund which are accounted for separately from the main fund portfolio. A side pocket may be used to separate a fund's illiquid assets from its more liquid investments (either in respect of a specific investment opportunity or to deal with troubled assets). Side pockets can be used to deal with illiquid assets and avoid the need to suspend redemptions (see below).

Generally new investors in the fund will not participate in existing side pocketed investments and the side pocket is not included in the fund's net asset value calculation.

Investors participating in the side pocket will be locked up until the underlying assets are sold by the fund (at which point they will receive their share of the cash proceeds or new shares or interests in the fund).

Traditional side pockets have been viewed negatively by investors since the last recession given the potential for them to be a source of tension between the manager and the fund's investors. For example, managers have in the past been accused of overvaluing side pocketed assets, leading to higher management fees from investors and the hiding of unrecognized losses. Some managers have also been accused of using side pockets to prevent new investors from participating in a particular asset or opportunity (thus avoiding investment returns being diluted). Accordingly, side pockets have become less common in recent years due to the potential for misuse and open-ended funds have increasingly turned to in specie redemption provisions to deal with illiquid assets.

Liquidating SPVs and *in specie* Redemptions. As a result of the reduced use of side pockets, open-ended funds have increasingly turned to in specie redemption provisions to deal with illiquid assets (in particular where funds do not have the ability to establish side pockets on the terms of the fund documentation).

Fund documentation often provides for investors to receive assets in specie directly from the fund or alternatively to receive interests in a SPV used to 'house' one or more illiquid assets until sold.

The establishment of an SPV should be carefully considered, in particular to avoid any regulatory and tax issues. The SPV may be established in the same jurisdiction as the fund to avoid double taxation. The SPV should also be structured to avoid investor consent rights over the operation of the SPV.

Suspensions. Standard fund documentation will contain limited suspension rights in certain specified circumstances, including where a fund's assets cannot be realized or valued fairly. The imposition of such rights suspends redemptions from the fund completely until the suspension is lifted.

Suspension of redemptions is often seen as a last resort and, in addition to encouraging investors to submit redemption requests (to be dealt with at the same time as all other suspended redemptions following the lifting of the suspension). Prospective investors will routinely ask managers whether or not they have ever had to suspend a fund; an affirmative answer may make it more difficult to raise assets in the future.

A decision to suspend will need to be made by the directors of the fund, who would need to determine that the suspension was in the best interests of investors – rather than the manager). It should be noted that fund documents drafted after the last recession usually contain more limited suspension rights, as investors generally were more sensitized to the issues.

Delayed Settlement. Managers may also consider delaying the payment/settlement of redemption proceeds (fund documentation normally includes some flexibility as to the timing of payment of redemption proceeds). Where relevant, in respect of Irish and Luxembourg domiciled UCITS, managers should be aware that the payment/settlement of redemption proceeds must be within 10 business days of the relevant dealing deadline.

Liquidation. In extremis and absent other tools being available or appropriate, prematurely placing the relevant fund into liquidation may be the most appropriate way to manage an orderly wind-down that treats all investors fairly.

Additional considerations

Any manager contemplating liquidity provisions should also bear in mind the following:

Portfolio Hygiene. A fund's redemption/withdrawal terms are required to be consistent with the underlying liquidity profile of its proposed investment strategy. Accordingly, it is important that managers are aware of those terms and keep a close eye on ensuring their portfolio remains consistent with the fund's redemption/withdrawal terms. In addition, now may be a good moment to check that the portfolio has been invested fully in accordance with the fund's investment policy, including with regards to any asset eligibility and investment restrictions.

Regulatory Obligations and Product Specific Rules. For managers subject to AIFMD, AIFMD's delegated regulation imposes a number of obligations with respect to liquidity management including, for example, the operation of appropriate escalation measures to address anticipated or actual liquidity shortages or other distressed situations (Level 2, Article 47 (3)). At this time, managers should be closely monitoring their liquidity measurement arrangements and procedures to assess the quantitative and qualitative risk of positions and intended positions (Level 2, Article 47 (1) (d)).

Fund of funds managers, should also be monitoring the approach adopted by the manager of the relevant underlying investment fund with respect to the management of liquidity. Managers should be conducting periodic reviews to monitor changes to the redemption/withdrawal provisions of the underlying investment fund in which the fund invests.

Managers will also need to consider if there are any specific product-related rules regarding the implementation and operation of any liquidity management tools (including those imposed by regulators in the domicile of the fund). For example, in circumstances where a suspension is declared, Irish and Luxembourg funds are required to notify their respective regulators immediately, and in any event within the working day on which the suspension took effect. In addition, in the context of Irish alternative investment funds, in order to effect a redemption in specie, investor consent will be required where the redemption request received from an investor represents less than five per cent of the net asset value of the fund. Further regulatory restrictions on the use of liquidity management tools are imposed on both Irish and Luxembourg funds.

Side Letter Liquidity Terms. If a fund or manager has entered into side arrangements granting certain investors preferential liquidity terms in respect of their investment, consideration should be had as to the legal and regulatory consequences of such terms.[1] For managers subject to AIFMD, the AIFMD's delegated regulation (Level 2, Article 23) also places an obligation on the fund's AIFM to ensure that "**any preferential treatment afforded** by an AIFM to one or more investors **shall not result in an overall material disadvantage to other investors**" [emphasis added]. Disclosure of preferential side letter terms would not by itself prevent an AIFM being in breach of Article 23 where the preferential treatment granted results in a material disadvantage to other investors. This is not to say that a fund cannot offer investors different classes with different liquidity terms (i.e. less liquid classes with lower fees) but this would need to be considered carefully given the wide scope of Article 23.

Accordingly, in determining whether or not an investor can be permitted to redeem on preferential liquidity terms in accordance with the terms of a side letter (for example, redeeming on shorter notice), the directors and the manager would need to consider the relevant regulatory obligations and the impact on other investors. Clearly if a fund was close to gating or suspending, it would be difficult to permit the redemption on shorter notice (especially if other investors have also submitted redemption requests which themselves were not received in time).

Other Clients (Funds and Managed Accounts). The foregoing restrictions on the preferential treatment of investors applies to investors within the same fund. However, managers may manage a number of funds and accounts with different liquidity profiles (i.e. a managed account may be terminated by a client on shorter notice requiring the manager to liquidate the account's positions more quickly than a fund that was otherwise trading *pari passu*). In managing each fund and account, the manager should carefully consider its trade allocation and conflicts of interest policies to ensure it does not unintentionally favor one client over another.

Key Person Provisions. In the event fund documentation includes key person redemption or other rights, managers should ensure they understand the terms thereof. Typically these will be drafted such that only an extended period of absence would trigger redemption rights (and thus short term illness should not be an issue).

[1] The same considerations would apply where preferential transparency rights have been granted (which might impact an investor's decision to redeem ahead of other investors in the fund).

3. Trading Counterparties

These times of unsettled and unpredictable markets taken together with general market uncertainty, potential investor redemptions and an expected general trend even if *pro tem* to a more conservative less risky operating environment mean there will be more focus by dealers globally on trading documents of all types (many dealers still bearing the scars from the events of 2008 and their aftermath).

Trading documentation

As a result of 2008 and the various Lehman insolvency proceedings, together with more recent disruptions, such as the 2011 special administration of MF Global, trading documentation has been tested like never before and these events have led to increased scrutiny and negotiation of trading document terms, changes in brokerage arrangements and generally stricter terms for asset managers and more discretion for dealers. Since 2008 the market has been more alive to the key risks and protections. Key for asset managers is visibility and data gathering on trading activity. Assessments should be made of:

- **Current exposures.** Where are the trading exposures of the funds under management? Are these exposures focused on derivatives or are they spread across derivatives, repurchase agreements and securities lending transactions, or even other transaction types? Which dealers are these exposures with and what agreements govern those trades? Are these transactions bilateral, cleared or exchange traded? Is there a repository of key terms and have these terms been analyzed recently? Managers who are in a position to answer these questions are better prepared for any trading counterparty issues, should they arise.

- **Trading document terms.** The key terms of the relevant trading documents should be considered, with main focus areas as follows. Our summary below focuses on ISDA and OTC derivatives documentation but similar issues arise and should be considered across trading agreements:

  - **Termination provisions**.

    - **Standard ISDA terms.** Several standard provisions of ISDA documentation should be considered in light of recent events and ISDA recently held a webinar for its members on the effects of COVID-19. The nature of the ISDA provisions and the fact that events are still unfolding means while there are no firm conclusions, aspects to consider include:

      - the force majeure Termination Event included in the 2002 ISDA Master Agreement. To trigger this event a number of conditions must be satisfied and there are a number of undefined terms in what is generally an untested provision. If successful, before any termination there will be a delay (so called “Waiting Period”) of eight days during which all payments and deliveries with respect to any affected transactions are deferred;

      - effects of market disruptions. Will market disruptions that may lead to events such as markets closing early or even full closures result in changes to the days on which payments, deliveries and valuations are due or can be made. Following the recent Philippines market closure ISDA issued guidance regarding the impact of this on ISDA standard documentation. The ability to serve notices and to set rates may also be affected by such events;

      - standard ISDA documentation includes a cross default provision which relates to defaults under borrowed money. For funds, borrowed money is often expressly extended to include derivatives and/or

prime brokerage transactions. Consider whether the ISDA cross-default may be triggered by defaults under other agreements. See below for further cross default related items.

- **Fund specific termination events.**

  - It is routine for fund trading documentation, in particular ISDA documentation in the form of Additional Termination Events (ATEs), to include monthly, quarterly and annual NAV triggers (or other analogous net worth based triggers for private equity funds and credit funds) and sometimes other NAV related triggers such as NAV floors too. The detail of trading documents and those termination events should be checked and relevant NAV levels recorded including importantly the basis for such triggers – are they performance based or absolute (i.e. including redemptions). Detail around how the NAV is measured and when it is struck is also crucial.

  - NAV triggers are likely to be the most common termination "sweet spot" across fund trading documentation but in the event a key person is affected by COVID-19, key person provisions should also be considered. The terms of key person provisions are often nuanced between funds and across dealers but could be triggered by a long period of illness and absence from the business. Other bespoke ATEs may also have been included such as material adverse change or restructuring related ATEs.

- **Margin provisions.** It is common for ISDA documentation to include widely drafted non-regulatory Independent Amount (IA) provisions. Dealers are also often designated as the sole Valuation Agent. Independent Amount and the Credit Support Annex (CSA) exposure calculation should be monitored carefully. As markets become volatile and exposures increase, margin calls may become more frequent.

- **Dispute rights.** Most ISDA documentation designates the dealer as Calculation Agent and many funds successfully secure bespoke dispute rights with respect to these calculations. If you query a Calculation Agent determination, these dispute rights should be checked and processes carefully followed.

- **Portfolio level terminations.** It is common for entities to enter into a full suite of trading documents with a given dealer and it is usual that if there is a default under one of these agreements, it will give the trading counterparty the right to terminate all other trading agreements entered into with either the dealer itself and/or its affiliates. Taken together with the ISDA cross default provision (detailed above), there is a risk of default contagion, both with respect to agreements entered into with a single dealer and across agreements with different dealers.

- **Other obligations.** You should check that all other obligations and requirements of trading documents such as documents to be delivered and any required notifications are up-to-date.

Counterparty Risk

The Lehman insolvencies and other events of the late 2000s did of course lead to increased regulation across aspects of trading documentation including following the 2008 Pittsburgh summit which resulted in the regulations many of us are now very familiar with, namely the Dodd-Frank Act and the European Markets Infrastructure Regulation (EMIR), and corresponding regulation globally. See below Section 5 (Regulatory Issues and Intervention) for more information on regulatory considerations.

The implementation of these regulations has led to an increase in exchange traded activity and cleared derivatives; some of that activity due to new mandatory requirements and others shifting because with increased regulation of

OTC derivatives, exchange traded derivatives and cleared derivatives can be a more efficient way to do business. This has served to decrease counterparty risk as exposures are moved from individual brokers and dealers to exchanges and clearing-houses. However, a manager who uses prime brokers should be aware how a fund's assets are held and by which dealers. As set out above in "portfolio level terminations", where funds have a full suite of trading documentation with a single dealer, defaults (as well as margin) are usually managed on a portfolio basis. Although post Lehman there was increased focus on segregated accounts and assets being locked-up, omnibus accounts remain routine and regulatory client money protection, if any, is generally expected to be limited.

Managing Margin and Collateral Requirements

For OTC derivatives, the most important considerations are familiarizing yourself with requirements relating to Independent Amount i.e. upfront non-regulatory initial margin and managing exposures so you are ready for the next margin calls.

Where margining is across portfolio or pursuant to the terms of prime brokerage documentation, it is likely that the relevant dealer will have a wide discretion to call for margin. Those discretions emphasise the importance of being aware of dealer's margin methodology and rights to dispute margin calls. Transfer timing provisions also assume greater importance.

Given the low interest rate environment, negative interest should also be considered. Terms of trading documents should be considered carefully in this respect but for OTC transactions, the ISDA 2014 Collateral Agreement Negative Interest Protocol enables parties to amend certain ISDA collateral documentation to provide for the payment of negative interest.

Next steps

- **Dialogue.** Engage with your dealers and ensure any potential defaults or other trading documentation related issues are discussed early.

- **Prepare.** You should be familiar with the terms of your trading documents and the process should a default occur including key aspects of the process and any notices you may have to prepare or respond to and any relevant time-frames. If you agree with a dealer to waive a NAV trigger or other default this should be evidenced by way of a formal side letter.

4. Considerations for Private Equity, Private Debt, Real Estate and other Private Closed-Ended Funds

Relevant considerations will depend on where the fund is in its life cycle:

Funds currently raising capital

- **Manner of fundraising:** fundraising will be heavily biased towards existing investors who are already familiar with the manager or new prospects who were already well advanced with their diligence before travel restrictions were implemented.

- **Extension of fundraising period:** funds which are currently raising capital in the market, but which have not yet held a formal first close, may consider extending the period during which they seek investor commitments before holding their first close. Otherwise, this may require investor consent.

- **Review of proposed fund terms:** it may be timely to review the proposed terms of the fund's documentation for those funds which have not yet launched, for example, by increasing the period between first close and final close, extending the investment period, evaluating the strategy, all with a view to maximize flexibility during this period of market disruption and beyond.

- **Review and amendment of fund documents:** managers should consider issuing a revised or supplemental PPM incorporating appropriate risk factors, updating the "Market Outlook" and "Investment Opportunity" sections and perhaps also the "Investment Restrictions/Guidelines" section (for example, if the PPM states that capital is expected to be deployed in a certain manner and this is no longer practicable, this section should be revised). Such amendments may also flow through to the LPA and other fund documents and if a manager has already held a first close and admitted investors, their consent to amending the LPA is likely to be required.

Funds in investment period

- **Extensions to commitment period:** an extension to the time during which limited partners' contributions are drawn down should be considered, to allow flexibility for investors and more time for the manager to source suitable investments.

- **Fund investments and deployment of capital:** managers may revisit timing and pacing of drawdowns and investments and the fund's overall terms to allow greater flexibility for deployment of capital during this time of market volatility.

- **Drawdown timing:** Where possible consider providing increased notice of pending drawdowns to investors to give them additional time to address their own liquidity issues. If the investor's ability to comply with funding timeframes in drawdown notices is impacted by any number of issues, such as, for example, the investor's bank suffering from business disruption issues, a manager may extend the funding timeframe so that investors do not inadvertently default. It is critical to communicate with investors during this time period to minimize and hopefully avoid defaults.

- **Strategy modification:** In terms of fund strategy, some managers are considering 'getting ahead' of any actual or perceived pivot in strategy at the fund level by reviewing the fund's strategy now to check that it is sufficiently flexible for the manager to participate in unforeseen investment opportunities that may arise. In the Global Financial Crisis in 2008/09 (**GFC**), we saw some limited partners asserting style drift as a reason not to fund drawdowns – in some cases this may be have been more motivated by their own liquidity issues.

- **Terms tweaks:** Managers may wish to consider increased flexibility around recycling of commitments, creating larger reserves (and correspondingly, reducing distributions to investors), increasing provisions for follow on investments, adjusting leverage, seeking co-investments and strategies for successor funds. These can all be used to liberate additional capital or retain the flexibility to deploy additional capital without additional primary fundraising.

- **Portfolio company considerations:** Managers are starting to consider how portfolio companies can be monitored effectively in a business world where travel is currently restricted or banned and many employees are working remotely. Areas to consider are the reporting obligations and processes by the portfolio companies to the fund and if any changes are needed for these to work effectively in practice over the next few months.

  Funds, and their portfolio companies, may need to revise their business plans and strategies to reflect current market disruption, as we saw happen during the GFC. Portfolio companies may be adapting their commercial strategies to satisfy evolving market demand. On the other hand, some managers will have portfolio companies in distress. Effective monitoring of risks and revisions to business plans and operating budgets within portfolio companies will therefore be key and this is also prompting managers to check disclosures made to the fund's investors to make sure there is sufficient flexibility for any commercial changes taking place in practice. This may be particularly relevant to joint ventures or other 'deal by deal' structures, where a particular business plan may have been 'sold' to investors at the fundraising stage.

  At an operational level, managers should consider and analyze the following more carefully than usual at portfolio company level: business continuity plans, contingency planning, information security, facility headroom, covenant strength and compliance, liquidity issues, supply chains, insurance, litigation risks, reporting deadlines, and public relation issues. The operational issues discussed above and elsewhere in this update in the context of the fund and its manager apply equally and in many cases more so at portfolio company level and also in terms of portfolio companies' suppliers and customers.

- **Practical considerations:** given the restrictions on movement and travel imposed by various jurisdictions, limited partner meetings, annual partnership meetings, limited partner advisory committee (**LPAC**) and investment committee meetings and processes should now be taking place virtually or by telephone. If there is any doubt, check the fund's governing documents to confirm these are allowed. In addition, thought should be given as to whether unintended permanent establishment issues for tax purposes may arise if board meetings cannot be held in the place of domicile of the GP.

- **Reporting deadlines:** reporting deadlines under both the fund's governing documents and statute (e.g. AIFMD) should be confirmed and monitored, including whether these can be met in practice or whether expectations should be managed about extensions. Interim or proactive reporting in the meantime is likely to be welcomed by investors (especially if there are specific issues arising), and we are seeing limited partners widely asking for more information now, not less.

- **Proactive management of investor issues:** During the global financial crisis certain managers were able to proactively boost their relationships with their investors by showing sensitivity to the issues their investors were facing, in particular the impact of the "denominator effect" whereby public market valuations resulted in investors being over exposed to private asset classes. The right course to take here will very much depend on the individual manager and investor group.

Funds nearing the end of life

Our separate OnPoint, ***Fund Restructuring Considerations for Private Equity*** (19 March 2020), details issues and restructuring options available to funds nearing the end of their term. These include the impact of the current market disruption on:

- funds in the "hold" stage of their lifecycle which are deploying reserved capital into successive series of funding rounds of their portfolio companies
- exit strategies from portfolio companies, where an exit is taking place now or expected in the near future
- the use of "annex funds" to provide later-stage follow-on funding to portfolio companies of a fund, where the fund has fully drawn down commitments from its investors
- co-investments and fund extensions. Although it may seem premature, as the market disruption caused by the COVID-19 pandemic continues to evolve, some managers are considering extensions to the term of a fund or looking to refresh end of life provisions, "while the going is [relatively] good"
- strip sales of part of a fund's portfolio and GP-led secondary transactions more broadly
- cross trades where certain investments are sold from one fund to another fund both managed by the same manager in order to take advantage of the latter fund's undrawn capital or longer fund life

Many of these options may involve some form of investor consent or consent from the LPAC, depending on the terms of the fund's governing documents. Even where investor consent is not expressly required, it may be advisable to consult with the LPAC or seek LPAC consent to address any actual or potential conflicts of interest. We expect to see managers using these tools, and other restructuring options which may evolve, as the current market disruption continues, to help preserve and enhance value for investors.

Consideration at the manager level should also be given to whether there may be any clawback liability and whether reserves should be taken against distributions to professionals. Usually the manager documents will provide for reserves but this should be checked.

Above all communication with investors will be key to maintaining relationships and investor confidence during this period of upheaval and turbulent market conditions.

5. Regulatory Issues and Intervention

The following addresses the regulatory response to the COVID-19 outbreak at the time of this writing. However, in this fluid environment, information changes very frequently and should be regularly checked.

Save where regulators provide otherwise, the outbreak of COVID-19 and the disruption it has caused, will not excuse a manager from compliance with its regulatory obligations. Therefore, managers will need to ensure that appropriate business continuity plans are in place to enable regulatory monitoring and reporting obligations to be met. These obligations may be subject to change. See below for the recent ESMA public statement with respect to the go-live for reporting pursuant to the Securities Financing Transactions Regulation (SFTR). There is speculation that the deadline for LIBOR transition may be delayed from end-2021 and also call for the next go-live date for the regulatory initial margin requirements to be delayed from this September.

Managers should also ensure that their compliance monitoring programs are kept up to date, in particular to include restrictions on the short selling of securities which are subject to bans and the disclosure of any long holdings in excess of specified thresholds.

United Kingdom

FCA short selling bans

The Short Selling Regulation (SSR) provides EU regulators and the UK Financial Conduct Authority ("FCA") with the power to apply short or long-term bans on short sales in shares, and certain other financial instruments. If an EU regulator (or the FCA), decides to impose a ban that regulator notifies other EU regulators, and the FCA, who then consider whether to do the same in their jurisdictions. The intention is to avoid short selling activity linked to particular shares moving to other jurisdictions where these shares are also traded.

Bar imposing two sets of one day short selling bans under Articles 23 (1) and 26 (4) of the SSR on a number of securities in response to bans imposed by the national competent authorities in Belgium, France, Italy and Spain, as of the date of publication, the FCA has made no policy interventions to mitigate the consequences of the market volatility following the COVID-19 outbreak. It is important to note that the Article 23 ban/restrictions are only for a single trading day, managers already holding short positions in banned securities would not have to unwind existing positions.

ESMA's lowering of the threshold for regulatory reporting of short positions

ESMA intervened more prescriptively on 16 March 2020, temporarily lowering the threshold for regulatory reporting of a net short position in shares traded on an EU regulated market to 0.1% from 0.2%. The requirements are now to report to the relevant national competent authority ("**NCA**") if the position reaches 0.1% of the issued share capital of the entity in question, and of each 0.1% above the threshold. The FCA confirmed that this will also apply to securities traded on a UK regulated market (e.g. the London Stock Exchange) though at a later date, given regulatory reporting at the new threshold requires changes to the FCA's technology to receive this information, which is not yet in place. In the meantime, firms should continue to report according to the previous thresholds, until further notice.

FCA expectations

Regarding FCA expectations, on 4 March 2020, the FCA issued a short statement setting out its high-level expectations of all firms following the COVID-19 outbreak (the "**4 March Statement**"), followed by an updated statement on 17 March 2020. Whilst the FCA has issued no further specific guidance for asset managers to date, the 4 March Statement gives a high-level sense of the FCA's expectation of how a contingency plan should address COVID-19.

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[3] Regulation (EU) No 236/2012 of the European Parliament and of the Council of 14 March 2012

The 4 March Statement

Within the 4 March Statement, the FCA makes clear that all regulated firms must have contingency plans for the COVID-19 outbreak and that it expects firms to:

(1) assess operational risks;

(2) ensure that they are able to continue to operate effectively; and

(3) take steps to serve and support their customers.

Further, the FCA stated that it expected firms to take all "reasonable steps" to meet their regulatory obligations, noting that these included entering orders and transactions into systems promptly, use of recorded lines and for staff to have adequate compliance support. Sensibly, the FCA noted that it would have no objection to firms operating from backup sites or with staff working from home if firms were able to meet the required regulatory standards when doing so.

Whilst many already will have been addressed as part of a firm's business continuity plan, we have set out below some considerations when assessing the 4 March Statement's priorities of operational risk, operational effectiveness and customer services and support.

Operational risk assessments

- Can the firm support its existing trading activity if the COVID-19 outbreak worsens significantly?
- Will services to customers be maintained at an appropriate level?
- How practicable is it for services currently provided from a central location to be provided by staff working from home?

Operational effectiveness assessments

- Has the firm identified any areas where trading volumes or withdrawals of investments may be much higher than normal or counterparty risk may increase as a result of market volatility created by COVID -19?
- What analysis has the firm done on the effect of COVID-19 on its service providers, specifically those providing critical or important outsourced operational functions and those in countries where there is COVID-19? For example, for a firm delegating portfolio management, does this firm have the ability to provide this service in its own right, in the event of difficulties at the delegated portfolio manager?
- What strategic, operational and investment decisions is the firm taking in response to this disruption, what scenario testing has it undertaken and how is it documenting these decisions and tests?
- Has the firm assigned responsibility for the firm's response to COVID-19 to an individual senior manager?
- Should the firm make a notification under Principle 11 (Relations with regulators) of the FCA's Principles for Businesses to the FCA on the disruption which COVID-19 may cause the firm?

Customer services and support assessments

- Will staff working remotely be able to enter orders and transactions promptly into the firm's trading and other systems to ensure good client outcomes and an orderly market?
- Will the firm's systems and controls for monitoring and recording conduct of business obligations (e.g. best execution) still be effective in covering the activities of staff working remotely?
- Are the firm's market abuse surveillance systems and controls effective for monitoring the decision-making and trading activities of staff working remotely and in ensuring that it can make suspicious transaction reports?
- Is the firm able to discharge its duty to record or copy telephone and electronic communications of its staff working remotely?
- Can a firm submit transaction reports to the FCA in relation to transactions executed or transmitted by staff working remotely? Consider other required reports (shorting/threshold reporting, Annex IV etc.).

"Reasonable steps" and FCA "emergency rules"

The 4 March Statement directs firms to "take all reasonable steps to meet their regulatory obligations". In the context of COVID-19, these would be steps that are commensurate with the nature, scale and complexity of the firm's business that the firm can demonstrate are designed to identify and mitigate operational risks, ensure the firm's effective operation and are taken to serve and support their customers.

GEN 1.3 of the FCA handbook contains a provision governing "emergencies" which sets out conditions that enable a firm to disregard an FCA rule if an emergency arises. This provision allows a firm to disregard an FCA rule if an emergency arises which:

- makes it impracticable for a firm to comply with a particular rule in the handbook;
- could not have been avoided by the firm taking all reasonable steps; and
- is outside the control of the firm, its associates and agents (and of its and their employees).

GEN 1.3. allows this for so long as: (a) the consequences of the emergency continue; and (b) the firm can demonstrate that it is taking all practicable steps to deal with those consequences, to comply with the rule, and to mitigate losses and potential losses to its clients. GEN 1.3 requires the firm to notify the FCA as soon as practicable of the emergency and of the steps it is taking and proposes to take to deal with the consequences of the emergency.

Therefore, firms should consider making a notification under GEN 1.3. Following this notification, it is unlikely that the FCA would take action against a firm for a rule breach, provided it can demonstrate it has assessed the risks of the breach carefully and done its utmost to comply, and has placed its customers' interests at the heart of its decisions on what to do.

United States

On 13 March 2020, the U.S. Securities and Exchange Commission ("**SEC**") issued an order providing relief to registered investment advisers ("**RIAs**") and exempt reporting advisers ("**ERAs**") whose operations may be affected by the COVID-19 outbreak. The SEC acknowledged that COVID-19-related disruptions may pose challenges to satisfying certain requirements under the U.S. Investment Advisers Act of 1940 and rules thereunder. In light of these challenges, the SEC provided temporary, conditional relief, from certain requirements relating to:

- Form ADV amendments and filings (applicable to RIAs and ERAs);
- Form ADV, Part 2 delivery (applicable to RIAs only); and
- Form PF filings (applicable to RIAs only).

In each instance, the exemptive relief is subject to the following conditions:

- The RIA or ERA is unable to meet the filing or delivery deadline due to circumstances related to current or potential effects of COVID-19.
- The RIA or ERA promptly notifies the SEC via email (IARDLive@sec.gov) and provides disclosure on its public website (or, if the investment adviser does not have a public website, it promptly provides equivalent notice to its clients and/or private fund investors):

  (i) Stating that the RIA or ERA is relying on the Advisers Act Order;

  (ii) Providing a brief explanation of why it could not file the Form ADV or Form PF or deliver the Form ADV on a timely basis; and

  (iii) Indicating the estimated date by which it expects to comply with the filing or delivery requirement.

The RIA or ERA must complete the filing or delivery requirement as soon as practicable, but not later than 45 days after original due date.

This relief applies to filing obligations for which the original due date was on or after March 13, 2020 but on or prior to April 30, 2020. The SEC may extend the period for relief (potentially with additional conditions) as necessary or appropriate.

It should be noted that, to date, we have not seen our clients take advantage of this SEC relief.

The SEC has also issued an order providing certain relief to registered investment companies. For additional information, please see ***SEC Takes Targeted Action to Assist Funds and Advisers in Light of COVID-19 Coronavirus Pandemic: Provides Temporary, Conditional Exemptions from Certain 1940 Act and Advisers Act Requirements*** (16 March 2020).

EU jurisdictions

EU regulators have been introducing short selling restrictions under the SSR, as well as other measures, on a daily basis in light of the current and ongoing market situation. Austria, Belgium, France, Greece and Spain have issued a one month ban on short selling, Italy a three month ban. Generally, the bans prevent creating or increasing net short positions on shares admitted to trading on venues in the respective jurisdictions, and include cash short sales, derivatives and indices. However, trading in index related instruments (such as futures and other derivatives) is excluded from the ban when the overall weight of the restricted shares in the relevant index is lower than (a) 20% in the case of Belgium, Greece and Italy, and (b) 50% in the case of Austria, France and Spain. For example, instruments based on the Euro STOXX 50®, STOXX® Europe 600, MSCI Europe, MSCI EMU indices are excluded from the short selling prohibitions.

As noted above, all EU markets have also been introducing lower reporting thresholds (0.1% of issued share capital).

In addition to the short ban, Italy has also temporarily enhanced its disclosure rules in relation to long positions in shares in 48 companies listed on the electronic stock market of Borsa Italiana. With effect from 18 March 2020, the minimum reporting threshold has been lowered to 1% for a non-SME and 3% for an SME.

Other jurisdictions

Several non-EU jurisdictions have also introduced short selling restrictions or other measures. For example, South Korea has introduced a six month ban on short selling until 15 September 2020. Other measures range from, in Australia, a request that large equity market participants limit daily trading volumes, to closure of the Philippines exchange until resumption of trading on 19 March 2020 (when initially announced closure was for an indefinite period, though it has since reopened). Other jurisdictions similarly have introduced other temporary measures (e.g. Malaysia, Taiwan, Thailand), or already had restrictions in place (e.g., China, Hong Kong).

Dechert's World Compass subscription platform maintains information on short selling and is issuing Alerts to provide regular updates.

General Regulatory Issues

Aside from the jurisdiction specific measures detailed above, managers should consider and be aware of the following regulatory issues and update their compliance monitoring program accordingly.

Product Specific Requirements (AIFMD and UCITS). Consider any product specific requirements. Ensure any risk management, liquidity management and valuation policies and procedures are up to date and have been stress tested, including in light of current environment. Ensure that adequate reporting lines are in place to ensure that the risk management function (whether internal or external) has effective oversight of the portfolio management function.

Compliance Monitoring Program. Ensure that the compliance monitoring program is kept up to date and under regular review to ensure compliance.

Managing Insider Lists. The fast paced developments means that asset managers should keep insider lists and the receipt of material non-public information under careful review. It will be important to distinguish between non-public information which is speculation and/or uncertain as opposed to information which is material and precise such that it would qualify as inside information.

Short selling. Aside from the short selling restrictions detailed above, managers should ensure that they are familiar with short selling restrictions introduced in other jurisdictions.

Circuit Breakers. Circuit breakers are measures introduced by exchanges to curb panic-selling. They apply both to broad market indices such as the FTSE 100 and the S&P 500 as well as to individual securities. Circuit breakers function by temporarily halting trading when prices hit predefined levels, such as a 13% intraday drop for the S&P 500.

SFTR reporting. On 19 March ESMA published a public statement with respect to the application of the SFTR. This statement acknowledges the impact the COVID-19 pandemic will have on preparations for reporting and conveys in the statement that it does not expect competent authorities to prioritise their supervisory actions for entities that would have been caught by the 13 April 2020 deadline (credit institutions, investment firms and relevant third country firms) until 13 July 2020. Trade repositories will not be required to register ahead of 13 April 2020 either. See our previous client alerts with respect to SFTR reporting. Your own position should be analyzed but many fund clients, where SFTR applies will be in scope for the 12 October 2020 deadline. On 20 March, the FCA updated its webpage on SFTR and confirmed its support for the ESMA public statement.

LIBOR transition planning. Ensure that you monitor LIBOR and benchmark related developments closely. LIBOR transition planning has been a recent high priority on the regulatory agenda. At the time of writing the FCA just issued a short statement confirming that the end of 2021 remains as a target date for all firms to meet (although it acknowledges that interim milestones would likely be affected), that the impact of COVID-19 and its impact on transition timelines will continue to be monitored and that the market would be updated as soon as possible.

6. General Contract Performance

The doctrine of force majeure and other legal theories may allow parties to adjust their contractual obligations in light of changed circumstances. The following addresses with some of the key concepts to consider.

Force majeure clauses. There is no general right to claim force majeure. It is something that has to be agreed within the terms of a contract. Thus, the circumstances giving rise to force majeure and the resulting relief depends on the precise terms of the contract.

- **Definition.** Typically, force majeure is defined in a contract as an event or circumstance that is beyond a party's reasonable control and cannot be overcome through that party's reasonable efforts. A contract may include a non-exhaustive list of events that constitute force majeure (which may include an epidemic outbreak). Careful consideration of the force majeure clause is required to determine whether the COVID-19 outbreak and/or any of the events resulting from it (e.g. travel bans, cargo quarantines, factory closures, etc.) qualify as force majeure.

- **Causation.** The force majeure clause will often state what impact the event must have before a party will be excused from liability for a failure to perform. Questions may arise to whether the force majeure clause applies where an obligation has not become impossible but merely more expensive, inconvenient and/or inadvisable to perform. For instance, can a party rely on a force majeure clause if its decision to cancel certain activities and/or close certain facilities are not mandated by law but self-imposed in an attempt to prevent the spread of the virus? To what extent is a party required to seek alternative suppliers if its original supply chain is disrupted? Is an unforeseeable drop in the demand for the goods being purchased by a party under a contract a sufficient basis for invoking force majeure? The answers will depend on the precise terms of the contract and the specific circumstances faced by the parties.

- **Notice requirements.** To invoke a force majeure clause, a party may be required to issue a formal notice to the other party within a certain period of time from the date the force majeure event occurred setting out certain information and particulars. In the wake of the confusion and uncertainty surrounding the COVID-19 outbreak, with many businesses initially taking a 'wait and see' approach, questions may arise as to whether the requisite notice requirements were observed and, if not, whether this might preclude a party from invoking the force majeure clause even if all other conditions are satisfied.

- **Consequences.** Contracts typically specify the consequences of a force majeure. This may range from a temporary suspension of the affected obligation to a right to terminate the contract altogether (e.g. where the force majeure persists for a prolonged period). There may also be provisions for an extension of time or a right by one party to be compensated for additional costs incurred. The terms of the contract will have to be examined to determine what rights a party has and whether any adverse consequences might ensue from a declaration of force majeure.

For additional information, please see ***English Law Considerations on Force Majeure, Frustration and Termination*** *(*18 March 2020).

General legal doctrines. Aside from any contractually agreed rights such as force majeure, a party may be able to rely on general legal doctrines to suspend, revise or excuse further performance under a contract. While the specifics vary from one jurisdiction to another, some broad principles common to a number of legal systems are considered below.

- **Fundamental change of circumstances.** In general, parties are bound by the contracts they make. However, many legal systems allow parties to be excused from the strict performance of a contract if a supervening event occurs that fundamentally or radically affects the parties' contractual obligations, renders performance impossible or otherwise frustrates the contract.

- **High threshold.** Although the content and limits of these legal doctrines differ, they generally require a high threshold to be crossed. Under English law, for instance, a contract is deemed frustrated if an unforeseeable and unavoidable event occurs that renders performance physically or commercially impossible, or which radically transforms the parties' obligations in a way they had not contemplated. Thus, before a party can rely on the doctrine of frustration to excuse contractual performance due to the COVID-19 outbreak, it will have to consider whether its obligations have been rendered impossible or merely harder to perform and whether reasonable steps could have been taken to avoid non-performance.

- **Consequences.** The positive application of the common law doctrine of frustration results in the contract automatically coming to an end, but there may be room to renegotiate the contract under civil law. Under German law, for instance, the parties may be obliged to renegotiate the contract if unforeseen circumstances significantly change the contract such that the parties would not have entered into it if the change were foreseen. Similarly, French law allows a party to request the renegotiation of a contract if its performance is rendered 'excessively onerous', and if the parties cannot agree on how to do so, the court may step in to revise or terminate the contract. A party that wishes to invoke a fundamental change of circumstances in the wake of the COVID-19 outbreak will therefore have to consider if it will result in a termination or merely a modification of the contract, and the desirability of either outcome.

This briefing was written by partners in **Dechert's private funds practice** across the USA, UK, Europe and Asia. For further information, please get in touch with your usual Dechert contact.

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