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# The Phases of a Hedge Fund Closure

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RFG represents a consortium of the nation's leading endowment investment offices. RFG clients seek a cost-effective, enterprise-focused solution to help them identify, and stay current with, evolving laws, regulations and transaction terms that impact day-to-day operations and investments.

# The Phases of a Hedge Fund Closure

[Finbarr O'Connor](#) of the Berkeley Research Group has written a [piece](#) examining the process for winding down a hedge fund. O'Connor notes that hedge funds most frequently close due to underperformance but events such as litigation, regulatory issues, key-man events and loss of members of the investment team may also trigger closure.

For investors, he highlights three key issues: clarity about timing of distributions, fees during the wind down and surprises about illiquid asset valuations. On the clarity point, O'Connor tells RFG that "In tail end situations investors' primary focus is on the timing and amount of their expected capital distributions." He adds that "... a key component for managers in developing their wind down plan is both an up front and ongoing investor communication plan that provides an estimate for distributions and the run off timeline. Investors also expect to see progress and often crave finality—a frustration we frequently hear from investors is that wind downs lose focus and control as they become extended, incurring unnecessary administrative costs disproportionate to the residual NAV."

As for the manager, O'Connor advises the manager (and if an offshore vehicle, the directors) to craft a timeline based on the nature of operations, the contractual terms in the fund's documents including side letters, input from the firm (management, operations, legal and accounting), and the method of returning capital to investors. As part of this process the manager should develop an investor communication plan, in which all investors are notified simultaneously, and consider whether and when to invoke the fund's gate. Other considerations during this phase include striving for equitable treatment of all investors, taxation issues, and handling any "loose ends" such as litigation and regulatory issues. The possibility of a lower management fee for the wind down holding period should also be considered at this point. O'Connor adds, "Fees are often an investor flashpoint in a wind down. To avoid any perceived conflict of interest, if the fund documents don't already provide for a wind down fee reduction, managers would be well served to consider a lowered management fee for any prolonged fund run off."

Next, O'Connor notes that "considerable analysis" should be devoted to individual investments "to manage the orderly exit of the fund's portfolio." Even for liquid assets, a "quest for immediate liquidity" can have negative price impacts. For co-investments, a variety of issues arise, such as "the co-investee's expectations on the timing and steps to achieve the harvest event." Consultation with outside counsel,

the fund's auditors and tax advisers is a necessary step, as is evaluating whether to disclose the fund's closure to other service providers and counterparties. Finally, during this phase, the potential closure of the manager platform may need to be addressed (including people, assets and overhead) and frequent communications with investors is required. Since illiquid asset valuations are another tail-end issue that concern investors, O'Connor advises that "To avoid surprises, managers would do well to test internal valuation models for those hard to realize final assets."

In the execution phase, the manager will finalize transactions, exit residual assets, resolve fund liabilities, undertake the required final liquidating audit, and work to prepare the K-1s of passive foreign investment company firms and other tax returns. In accordance with the requirements of the relevant jurisdiction, the manager must dissolve the fund and manager entities, and then possibly withdraw its registration or revise filings (such as its Form ADV-W) with the SEC and other regulators. Lastly, final notices and investor distributions are processed, and "the receipt of this distribution and capital statement, together with their copy of the liquidating audit and K-1s, will typically be the last formal interaction investors will have with the fund."

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