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A legal update from Dechert's Financial Services Group

Considerations by Managers of Private Funds in Light of Potential Eurozone Crises

European financial markets have experienced volatility and have been adversely affected by concerns regarding rising government debt levels, credit rating downgrades, and possible defaults on or restructuring of government debt of various countries, most notably Greece. These events have affected the value and exchange rate of the euro and have had varying impacts on fund strategy, performance, investments, operations, liquidity and counterparties.

This turmoil has fed speculation that one or more European Union Member States that have previously adopted the euro might choose or be forced to abandon the euro and return to a national currency. Further, there is great uncertainty as to whether the euro can continue to exist as a single currency following a departure of one or more countries from the currency mechanism. Such events could have a dramatic impact on many aspects of fund management and investment, particularly for euro-denominated funds.

Managers of private funds (Managers) should consider how such events may affect their funds and evaluate what amendments, if any, may need to be made to fund documentation in order to provide them with sufficient tools and discretion to effectively manage the impact of any such developments.

Offering Document Disclosure: Investment Strategy and Risk Factors

Depending on a fund's investment strategy and restrictions, the fund may be adversely affected by a sovereign's rating downgrade, a country withdrawing from the euro and/or general market turmoil resulting from such events. A fund that is denominated in euros or that invests in instruments predominantly tied to Europe or the euro (whether directly or indirectly through derivatives) will be significantly exposed to the increasing volatility of the European financial markets. The sections of the fund's offering documentation discussing the fund's investment strategy, investment restrictions and investment objective should set forth important details regarding, among other topics: (i) the currency denomination of the fund or a particular class of shares; (ii) necessary and/or desired credit ratings of (the applicable portion of) the fund's investments and counterparties; and (iii) Manager obligations upon a credit rating downgrade of an investment or counterparty (*e.g.*, obligation to sell investment position, cancel position with a downgraded counterparty and/or notify investors). Managers should consider whether the current requirements or obligations set forth in these sections are applicable and reasonable in the current environment and whether it may be necessary to update any restrictions and/or provide the Manager with additional investment flexibility or discretion in the event of downgrades or other related matters.

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Managers should also review and update the risk factors set forth in fund offering documentation as necessary to reflect risks associated with any current or potential eurozone crises. In addition to discussing recent events such as credit rating downgrades and financial market volatility, Managers should consider adding in-depth disclosures regarding the impact a breakup of the eurozone or abandonment of the euro by one or more countries could have on the fund, its investments, counterparties and service providers.

In conjunction with adding to or updating eurozone risk factors, Managers should also consider whether updates are required to other regulatory documentation. For example, Managers that are U.S. registered investment advisers should update their Forms ADV with similar risk disclosure. Specifically, Item 8B of Form ADV Part 2A requires Managers to detail the material risks associated with particular strategies. As Managers of pooled vehicles generally satisfy this Item by providing an overview of the material risks for their fund strategies, Managers should update this Item as necessary (and in a manner consistent with any updates to their funds' offering documents) to highlight any particular eurozone risks that have the potential to significantly impact the Manager or its funds.

Amendments to Governing Documentation and Policies

Managers should also consider whether they have sufficient management tools and flexibility to effectively weather a eurozone crisis. Such tools may include the ability to establish side pockets, amend a fund's valuation methodology, and restrict redemptions and redemption payments.

Should a eurozone crisis result in one or more countries abandoning the euro, it may be difficult subsequently to value investments denominated in euros or in a replacement currency. In this event, Managers should ensure that the fund's valuation procedures have detailed provisions setting forth how such instruments should be valued in such extraordinary circumstances, including what entity (*e.g.*, the Manager or the administrator of the fund) is responsible for determining such valuations. Fund documents should also provide the Manager, board of directors or other applicable entity or body the discretion to declare a suspension of the fund's determination of net asset value should a eurozone crisis create a state of affairs that, in the opinion of the responsible party, constitutes an emergency, rendering determination of net asset value not to be reasonably practicable for the fund.

Managers should also consider providing the authority to establish side pockets that permit Managers to separate hard-to-value assets from the remainder of a fund's portfolio. Managers generally create side pockets by converting investor shares/interests attributable to the assets to be side pocketed into a new class of non-redeemable shares/interests that are held until the asset becomes liquid or is otherwise deemed realized by the Manager. In order to be able to most effectively utilize side pockets, a Manager must ensure that the relevant fund documentation allows for the reclassification of such assets and the ability to create new classes of shares/interests that are not freely redeemable by investors. The documentation should also set forth the circumstances in which a Manager may create side pockets and determine when the relevant assets become liquid enough to be redeemed by investors (or in the context of a eurozone crisis, when a new currency has been adequately established such that proper valuation can occur).

In addition to dealing with valuation difficulties, in the event of a eurozone crisis, Managers will likely be forced to deal with various issues concerning redemptions. Specifically, Managers may face a larger volume of redemption requests, both in the overall number of requests and in the increased value of the requested redemptions. In such circumstances, Managers may also have difficulty processing such requests because of liquidity constraints. Managers should therefore carefully review fund documentation to ensure that they have incorporated sufficient tools to deal with redemption concerns, such as the ability to use gates, suspend redemptions and redemption payments, and pay redemptions in-kind.

Gates enable Managers to limit the amount of redemptions allowed on a particular redemption date and provide procedures for deferring the redemption requests not granted. Managers should ensure that they have sufficient discretion to determine when to use a gate or that the fund documentation otherwise implements an automatic gate once redemption requests reach a specified threshold; such threshold should be reexamined to ensure that it is reasonable to investors but also practical in the prevailing environment.

Finally, to the extent amendments to the fund's governing documentation or policies are necessary to account for any of the foregoing considerations, Managers should determine whether the consent of the

fund's investors is required. If so, Managers should consider obtaining such consents at the earliest feasible time so that a Manager is not restricted from taking appropriate action upon the onset of a crisis.

Currency Denomination

Managers that have euro-denominated funds or funds with euro-denominated share classes should consider the implications of: (i) the elimination of the euro as a currency; and (ii) circumstances in which it is no longer reasonable to maintain the fund or applicable share classes as euro-denominated (*e.g.*, where a significant number of countries exit the euro, reverting back to utilizing individual currencies). Such Managers should consider whether it is prudent to preemptively re-denominate their funds or applicable share classes. Even if a Manager decides not to make any such re-denominations currently, it should ensure that it has the authority to do so whenever it deems necessary in the future. Managers should determine whether a fund's current documentation permits such re-denominations — if not,[1] Managers should consider making any necessary amendments to fund documentation as early as possible for the same reasons outlined above, especially if such changes require a form of investor consent.

In addition to re-denomination considerations, Managers may also want to consider the circumstances under which it would be preferential or prudent to wind up euro-denominated funds or eliminate euro-denominated share classes. Managers should therefore consider what kind of discretion Managers are provided under the liquidation and compulsory redemption clauses of their funds' governing documents, as applicable, and determine whether it is necessary to update such sections to provide sufficient discretion. While any determination will depend on the current terms of the fund's governing documentation, it is often the case that such updates would require some form of investor consent; accordingly, Managers should consider obtaining such consents at the earliest feasible opportunity.

Finally, Managers should consider what, if any, alternative currency and currency conversion ratio should be selected and what discretion the Manager currently has or would like to incorporate into the fund documents in order to make such determinations, with similar considerations applying to any amendments necessary to grant the Manager such discretion.

Ability to Hedge Risk

In conjunction with considerations regarding potential eurozone crises, Managers should consider how they can best hedge the currency and exchange rate risks inherent in fund portfolios and whether the fund governing documents currently provide them with adequate authority to do so.

In the face of numerous eurozone crisis scenarios, fund documentation should allow for currency hedging transactions with regard to specific investments, as well as the operation of the fund itself. If fund documentation does not clearly provide the Manager with the discretion to engage in such transactions, the Manager should consider amending all relevant documents to broadly provide for such authority, thereby enabling the Manager to better protect both the fund and its assets against the exchange rate volatility that is likely to increase during and in the aftermath of a eurozone crisis.

In circumstances where Managers have existing derivative contracts hedging the currency risk of a fund and/or its investments, Managers should review these contracts to ensure that risks arising from a eurozone crisis are adequately addressed. For example, the 2002 ISDA Master Agreement (the 2002 ISDA Agreement) contains a provision that allows for the termination of a transaction due to a force majeure event. A force majeure event either prevents, makes impracticable or makes impossible a party's performance or compliance with a material provision of the 2002 ISDA Agreement or a transaction thereunder, such as a currency forward or a similar currency hedging transaction. In addition, the force majeure event must be beyond the control of the parties and the parties could not, using reasonable efforts, overcome such impossibility. Under the 2002 ISDA Agreement, the use of "reasonable efforts" does not require a party to suffer losses, other than immaterial or incidental expenses. The 1992 ISDA Master Agreement does not contain a similar force majeure provision. If a Manager's funds are not using the 1992 ISDA Master Agreement, it is possible to amend the 2002 ISDA Agreement to remove this provision.

[1] If current fund documentation is silent regarding a potential re-denomination, Managers should consult with counsel to determine whether amendments are necessary to permit such re-denomination.

In addition, ISDA's 1998 FX and Currency Options Definitions (the 1998 Definitions) set forth a number of "disruption events" that could provide a basis for the termination of a Manager's currency hedging transaction. For example, a "Dual Exchange Rate" event occurs if the currency exchange rate specified in a transaction splits into dual or multiple currency exchange rates. A "Material Change in Circumstance" occurs if any event "makes it impossible" for the parties to fulfill their respective obligations under a transaction. Upon the occurrence of either of these events, the 1998 Definitions provide for no-fault termination of the affected transaction (*i.e.*, the parties may terminate the contract in the same manner as if a force majeure event occurred).

In the absence of guidance from the standard ISDA documentation or ISDA definitions, the inability by a party to perform under a contract would likely be governed by the "frustration of purpose" doctrine under New York law (if applicable) or similar impossibility principles.

Finally, Managers should ensure that adequate and clear disclosure has been made regarding the risks and implications of utilizing such hedging contracts and any other derivative instrument or other currency-related transaction permitted under the fund documents.[2]

Conclusions

As highlighted above, because of current and potential eurozone risks, Managers should preemptively review their fund governing documents, ensuring that they have necessary discretion and flexibility to take action should liquidity tighten, assets become illiquid or the euro cease to exist. Managers should also ensure that their discretion with respect to such actions is disclosed and that they have incorporated applicable risk factors sufficiently detailing current and potential eurozone crises and related risks to the fund, investments and service providers, including counterparties. Managers may find it convenient to provide notice of updates to fund documentation by providing existing investors with supplements or amendments, as applicable, to such documentation and subsequently incorporating updates into the body of existing documentation for prospective investors to review.

As part of their holistic review of fund documentation, Managers should review any investor and board of director consent requirements necessary to authorize any action the Manager may wish to take in the event of a crisis (*e.g.*, those actions that may alter investor liquidity, otherwise materially impact other investor rights or impact the investment strategy of the fund). Now is the time to put investors on notice of potential actions the Manager may take in response to a eurozone crisis and to seek investor consent to any amendments to fund documentation granting additional Manager discretion and flexibility. Managers should also review any side letters, subscription agreements or other documentation that may provide special liquidity, information or notification rights to individual investors; such special rights may further impact Manager discretion and flexibility and may need to be amended as appropriate.

As a matter of investor relations, Managers may want to consider providing an explanatory letter or other client communication that is sent to existing investors along with any fund documentation update that puts the eurozone crisis in perspective, highlights the most relevant and serious risks, and details any related actions the fund has taken to protect itself and its investors from such risks. Additionally, Managers should take time to prepare uniform responses to likely investor questions regarding the current environment, potential eurozone crises and the related risks to the fund, fund investments and fund investors.

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[2] For example, in light of recent controversies over whether the Greek government's various restructurings of Greek sovereign debt represented "credit events" for purposes of credit default swaps (CDS) referencing such debt, Managers should consider whether hedging instruments the fund has entered into will function as intended due to the inevitable political considerations relating to any potential sovereign debt (or otherwise).

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