

# Securities Law

## Hedge Funds

### Withdrawals & Redemptions

#### Gates, A Primer (Parts One and Two)

*Contributed by David J. Lestz,  
Counsel, Sidley Austin LLP*

#### Part One:

Redemption gates have been applied more than ever before in the past few years. This article discusses various aspects of gates that should be considered by managers and investors, including different types of gates and their various features, drawbacks and benefits within the overall context of liquidity issues confronting hedge funds. As such, it provides a framework for discussion related to the establishment of a gate and negotiation between a hedge fund and its investors with respect to the gate's attributes. Gates which apply on a fund-wide basis and gates that apply on an investor by investor basis are addressed.

#### What Is a Gate?

A gate is one of the tools available to craft the liquidity terms of a hedge fund. A gate partially limits the ability of investors to redeem from a fund. This is unlike a typical suspension provision, which completely and temporarily prohibits redemption.

#### What Is the Purpose of a Gate?

A gate functions as a brake on the pace of redemptions, slowing the redemptions to a rate at which they should have a reduced or otherwise limited impact on the value, liquidity, and concentration of a fund's portfolio.

Designed appropriately, a gate is a useful tool in select situations. It can (1) reduce the risk of over-concentration in certain investments (due to sales of more liquid investments to raise cash while retaining less liquid investments that cannot be easily sold) by providing limits on overall redemptions without having to resort to a suspension; (2) permit investors to be relatively assured of redeeming a certain proportion of their investment on a given redemption date (for example, a well-designed 20-percent gate gives an investor reasonable certainty (barring the use of other provisions such as suspension and side pockets/designated investments) of receiving 20 percent of the current value of its investment on a redemption date); and (3) reduce the "piggy bank" or "ATM" effect, that a more liquid fund might be subject to substantial redemption requests, because it has better liquidity terms, as distinguished from redemption requests submitted out of the investor's performance concerns or ordinary rebalancing.

**A gate should be designed so that it does not, if invoked, encourage redemptions or redemption requests.**

A gate should be designed so that it does not, if invoked, encourage redemptions or redemption requests. In particular, a gate should not provide additional benefits to the redeemer based on the timing or size of redemption requests. The gate design should not provide the investor with a reason to protect itself by

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submitting earlier or larger redemption requests than the investor otherwise might desire. A poorly designed gate can have the unintended effect of accelerating redemption requests, effectively creating a race to the exit by investors, and possibly compelling the dissolution of a fund that might otherwise have survived.

To the extent that a gate slows the pace of redemptions, it also preserves the management fee for the manager, and therefore its ability to pay and retain its employees. A gate, in reducing redemptions, also lowers the risk of crossing a prime brokerage or swap counterparty threshold or trigger that could require further liquidation or reduction of exposure in the fund's portfolio.

### Does Every Fund Need a Gate?

No. First and foremost in determining the need for a gate, as well as in designing a gate, is the liquidity profile of the investment portfolio. A very liquid fund, such as a typical managed futures fund or quantitative equity long-short fund, for example, often does not require the protection of a gate. The assets of a very liquid fund can be liquidated with minimal breakage costs and without impacting the value, liquidity, or risk profile/concentration of the remaining portfolio. In contrast, a distressed debt, credit or real estate fund, for example, often is helped by the presence of a gate should significant redemption requests be submitted, as may occur during a time of market stress. The designer must appreciate that a fund gate, while a useful tool, is more like a hammer than a scalpel. Well crafted liquidity provisions should reduce the likelihood that this mechanism will be used, permitting the fund instead to rely on its ordinary notice and redemption provisions.

### Types of Gates: Fund Gate and Investor Gate

A fund gate limits the aggregate amount that all investors in a fund are permitted to redeem. For a fund gate, the amounts that all investors request to redeem are combined and measured against an overall threshold. To the extent the threshold is exceeded, the requested redemption amounts are reduced as provided for in the fund documents.

An investor gate is an investor by investor limitation that restricts the amount which an individual investor may redeem, without regard to the amounts that other investors are redeeming. It effectively staggers each investor's partial or complete redemption from a fund.

### Fund Gate Design

A gate should (1) be equitable to both redeeming and remaining investors; (2) not create incentives to submit earlier or larger redemption requests, *i.e.*, not create a race to the exit situation; and (3) promote and preserve the overall stability of the portfolio.

The following factors should be considered by managers when designing a fund gate and by investors when evaluating or seeking modifications of a fund gate.

#### – Who Is Subject to a Gate?

In a master-feeder structure, one of the first questions in designing a gate is at what level should the gate be imposed? Fund structures may impose a gate at either the master or the feeder level. Investors generally consider it more equitable to implement the gate at the master fund level, unless a substantial portion of investments are made directly at the feeder fund level. For example, assume a master-feeder structure in which the domestic feeder fund has \$200 million, the offshore feeder fund has \$800 million, and the gate is set at 20 percent. If the gate is at the feeder fund level, the most that could be redeemed from the domestic fund would be \$40 million, while \$160 million could be redeemed from the offshore fund. Therefore if two investors, one domestic and one offshore, submit redemption requests of \$50 million each, the domestic investor would be gated at \$40 million with \$10 million deferred. Meanwhile, the offshore investor would receive the entire \$50 million request. Since both requests are fulfilled from the same portfolio, the "equitable" result to the investors would be a 20-percent payout (consistent with the master fund's expected tolerance for redemption liquidity). This is more of a benefit to the manager, since had the gate been at the master fund level, the overall gate threshold would have been \$200 million and the full redemption requests would have been paid out. Any breakage costs or negative impact would be at the master fund level and not the feeder fund level. Therefore, having the gate at the master fund level links the gate more precisely to the potential impact on the portfolio.

This logic does not apply when a substantial portion of a feeder fund's investments are direct and not through the master fund. In such an instance, the feeder funds are more akin to side by side funds. Unlike a master-feeder structure, most side by side funds calculate their gates on an individual basis. While the total amount of investments being sold may be equal to those in a master fund structure, the costs in this case would be borne on a disproportionate basis and so would the risk of over-concentration due to the sale of more liquid investments and the retention of less liquid investments by a specific fund. Therefore, it is more equitable to maintain the separate gates for side by side funds since they do not have a common trading portfolio.

An additional alternative for master-feeder structures, which have investments at both the master fund and feeder fund levels, is to place gates at both fund levels. This is to avoid impacting the value, liquidity, or risk profile/over-concentration of the remaining portfolio at either level of the fund's structure.

To the extent a gate is calculated on an aggregate basis at the master fund level, the gate should capture the assets and the redemption requests of all feeders including future feeders. If a gate is written too specifically, *i.e.*, only with respect to two named feeders, consent may be needed if a future feeder is added.

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**– Gates Should Be in Sync with Redemption Dates**

Gates should match the redemption frequency of the fund. A quarterly fund-level gate works well with quarterly redemptions, but poorly with monthly redemptions. Assume for this example, two investors in a fund, each with a \$50 million investment, a quarterly gate of 25 percent and redemptions on a monthly basis. One of the two investors requests a \$25 million redemption in the first month of the quarter. Upon the fund fully paying out on the redemption request, there is no more capacity to pay out on any additional requests in months two or three of the quarter. This incentivizes an investor to submit redemption requests earlier in the quarter, creating a potential “race to the exit” each quarter. This “mismatch” can be avoided by implementing one or more of the following strategies: (1) change the gate to monthly; (2) have separate series, with each series subject to its own gate (*e.g.*, a monthly series would have a monthly gate and a quarterly series would have a quarterly gate and such gates would not be combined); (3) have each gate only include the amounts that are available to be redeemed (*e.g.*, a quarterly gate would include monthly and quarterly investments, but not annual investments that were not redeemable during such quarter); or (4) during the non-quarter end months, only permit redemption of up to the amount that the investor would be guaranteed to receive during the quarter if all investors exercised their maximum redemption right, with the remainder to be paid using any available capacity under the quarter-end gate, *i.e.*, each investor subject to a 25-percent gate can take out up to 25 percent of its investment in aggregate during January and February, and the remaining amount under the gate in March. In the author’s experience, most managers when faced with the potential complexity of the above solutions opt to not offer monthly redemptions with a quarterly fund-level gate. However, investors are increasingly requesting monthly redemptions. A key challenge with increased frequency of redemption dates is the appropriate gate size.

**– Size of Gate/“Protective Redemptions”**

Selection of the gate size depends on the liquidity of the portfolio, the manager’s requirements for stability, and the frequency of redemption dates. A long-short equity fund generally will have a larger gate than a distressed debt or credit fund. A monthly gate often will be lower than a quarterly gate. Typically, a quarterly gate for a long-short equity fund will range from 20-25 percent. Distressed debt or credit funds tend to have a quarterly gate closer to 15 percent. When reducing the size of a gate due to more frequent redemptions, the size of the gate is usually only decreased modestly, *i.e.*, down approximately 5 percent of fund

size. A monthly long-short equity fund gate will often be reduced to approximately 15 percent. In comparing monthly and quarterly gates, one should not simply divide the amount of the desired quarterly gate by three. The gate would be so low that it would be easily tripped. Tripping the gate is undesirable for a fund, because of the negative signal it sends to the market. The possible consequences include potentially creating a death spiral for the fund as other investors become nervous about being able to redeem out of the fund. The newly concerned investors may begin to submit protective redemption requests (*i.e.*, a request to assure their place in line to get a redemption request filled, but which will be wholly or partially withdrawn if investor confidence increases prior to the effective date of redemption), thereby increasing the likelihood the gate will be triggered again, creating a vicious cycle.

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**– Date of Determination**

The date as of which the fund determines whether a gate threshold has been reached may be either the date by which notice must be received by the fund or the date on which the redemption is effective. If it is not specified, the determination date is generally considered to be the effective date of redemption. The distinction manifests itself (1) when certain redemption requests are submitted for fixed dollar amounts as opposed to percentage-based redemptions; and (2) if the total redemption amount is determined on a “net” basis, after offsetting investments. Since subscriptions for offsetting investments are typically not received until close to, or on, the effective date of redemption, if offsetting subscriptions are used, the gate should use the date of redemption as the effective date of determination. In addition, to the extent requests are withdrawn, using the effective date of redemption may be beneficial as it reduces the likelihood of the gate being triggered.

**– Gate Usage**

In selecting the size of the gate, the manager should keep in mind that it may not want to impose the gate for small amounts above the gate threshold. Generally, when the gate has been barely exceeded, such as 27-percent redemption requests with a 25-percent gate, it is often preferable to lift or waive the gate, rather than impose the gate. This is similar to not using an insurance policy if one is only a little over the deductible because it could increase future insurance premiums. So, imposing the

gate when the redemption requests are only a small amount over the gate could result in bad publicity, market concerns, and greater future redemption requests. However, any gate waiver or lifting of the gate should only be permitted if the manager determines that the higher redeemed amount will not violate its operative documents or overall fiduciary duty to the fund and the remaining investors.

Should circumstances change, the gate may become too high, such as where the portfolio has become less liquid to an unanticipated degree. If the manager is not comfortable with the amount that can be paid out under a gate, the manager may be forced to suspend fund redemptions as a whole.

#### – What Does Pro Rata Really Mean? - Avoiding Race to the Exit Situations

When a gate threshold is reached and no priority based on the timing of redemption requests applies, the gate is typically invoked on a *pro rata* basis. *Pro rata* is conventionally interpreted in one of two ways: (1) based on the size of each redemption request; or (2) based on the size of each redeeming investor's investment immediately prior to the redemption. It is beneficial to have redemptions *pro rata* based on the size of the investor's investment because it enhances stability of the fund, as demonstrated below.

Allocating the available liquidity *pro rata* based on the size of the investor's redemption request creates an incentive to redeem earlier and redeem larger amounts, as the following example demonstrates. Assume a 10-percent gate and two investors; Investor 1 has \$1 million invested and Investor 2 has \$10 million invested. Since the fund totals \$11 million, the 10-percent gate limits redemptions to \$1.1 million. Investor 1 submits a request to redeem \$1 million and Investor 2 also wants to redeem \$1 million. If the gate is applied based on the size of the requests, each investor would receive \$550,000. Investor 2, in order to increase the probability of receiving the \$1 million it wants, instead of putting in a request for the amount that it actually wants to redeem, may take into account that the gate is based on size of the request and then request a "protective" \$10 million redemption to assure that it will receive the \$1 million it wanted. This fosters a race to the exit.

In contrast, if the *pro rata* treatment is solely applied on the amount of the investment of each investor, Investor 2 can ignore what the other investors might request. In this example, Investor 2, by submitting a request for \$1 million, is assured (assuming no other redemption features are triggered) of receiving the amount of its request. Under the gate in the example, it will at least receive its portion, \$1 million, *i.e.*, 10 percent of its \$10 million investment. Investor 1 would similarly receive 10 percent of its investment, a \$100,000 redemption. Therefore, investors are secure in submitting their actual desired redemption amounts, since there is no benefit, and therefore no incentive, to increasing the size of their redemption requests. The small investor also benefits from the increased stability of the portfolio and the decreased likelihood of the gate being implemented due

to protective redemption requests. The small investor does lose the benefit of having its redemption request treated the same as a larger investor and receiving the same amount as a larger investor were the same size request to be made by each. However, "favoring" larger investors in this manner enhances the overall stability of the fund, benefitting all investors.

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**Granting priority to earlier redemption requests is generally more harmful than helpful. This may seem counterintuitive, but it proves to be true.**

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Often a fund, in particular an older fund, is not specific as to which interpretation applies. The fund documents simply provide that redemptions are reduced on a *pro rata* basis. If the basis is not stated, the documents should be amended and any ambiguity corrected. However, in the absence of such a clarification or correction, documents silent as to the basis are generally interpreted such that a *pro rata* reduction will be based on the size of the request, the less desirable alternative. This interpretation results because the documents often state that redemptions will be reduced *pro rata*, which seems to refer back to the redemptions themselves as opposed to the size of the redeemers' investment amounts. There are exceptions to this general rule, but typically only when there is other documentation to the contrary or which otherwise further clarifies the phrase *pro rata*.

#### – Should Earlier Gated Requests Have Priority?

Granting priority to earlier redemption requests is generally more harmful than helpful. This may seem counterintuitive, but it proves to be true. Though giving priority to an earlier request that was not fully redeemed may seem equitable, it is disadvantageous to the operation of the gate and the fund. The priority increases the incentive to redeem sooner and faster than the investor might otherwise desire. Relying on, or being concerned about, the priority, an investor may make an early request just to assure or otherwise enhance its chances of getting money out by its desired time. Consider for example, an investor that knows it will need its money in July. Instead of submitting its request for the June redemption date, it may decide to submit its request one quarter earlier, in March. The investor does so because were it to wait for the June redemption date and a gate were implemented in March, it is more likely to be partially or completely gated in June, since the gated March redeeming investors have priority for redemption. In contrast, without priority based on the date of a request, as long as an investor is requesting to redeem less than the gate percentage amount, it has no extra incentive to submit its request any earlier than the date that the redemption is actually desired.

### – Clean-Up Provisions

A typical investor concern is that it will be perpetually gated. For example, assume a \$100 million fund with a 25-percent quarterly gate and no gain or loss. The gate permits the following payouts by quarter: \$25 million in the first quarter; then \$18.75 million of the remaining \$75 million in the second quarter; in the third quarter, \$14.06 million of the remaining \$56.25 million; in the fourth quarter, \$10.55 million of the remaining \$42.19 million; and there will be a little more than \$31 million still remaining after four consecutive 25-percent gates are imposed. In order to alleviate this concern and assure an investor that it will get paid out within a year, a clean-up provision may be incorporated. The clean-up provision might provide that the investor will be paid the balance of any request that has been gated for three previous quarters in the fourth quarter. This gives significant comfort to investors, while having minimal impact on the stability of the fund. The manager has ample planning time to meet such known redemption requests, and the investor has comfort from the relative certainty of knowing when it will ultimately get its final payout. A typical length for a clean-up provision, *i.e.*, the number of redemption periods that must pass, is equal to one divided by the gate percentage, although some are shorter, typically because of investor demand. Any excess paid out under the clean-up provision will generally be excluded from the gate with respect to the other investors, but is dependent on the operative documents.

### – Offsetting Subscriptions

A fund- or investor-level gate may be applied based on total redemptions or net redemptions (*i.e.*, redemptions net of subscriptions received on the same date). Often it is applied on net redemptions since cash from subscriptions can generally be paid out without adversely affecting the remaining investors.

Investor-level gates should be designed to accommodate redemptions with corresponding offsetting subscriptions without being distorted by a gate. For example, an investor or related group of investors may desire to alter positions by having certain related investors subscribe while others redeem, *e.g.*, the result of different investment mandates. The offsetting subscriptions should be applied prior to any determination of the gate. This is important to avoid having to jump through hoops to avoid an investor subscribing for an increased investment or, worse, electing not to subscribe for fear of increasing its overall aggregate investment.

### – Redemption Fees

For funds where the portfolio can cover additional redemptions beyond the amount permitted under a gate with limited breakage costs, a redemption fee can be a useful tool. For a predetermined fee, an investor is permitted to redeem additional amounts. Generally, the fee is paid to the fund or, if a master-feeder structure, to the master fund. The fee should be at least sufficient to cover the breakage costs, 2-5 percent being the most typical. The fee may be implemented in a variety of ways. It can

be charged on the entire amount of the redemption request, regardless of whether a gate is applied, or it can be applied only on the amounts that would otherwise have been gated. For administrative ease, the election to pay the fee may be required at the time of the redemption request and not after it has been determined that the gate will be implemented.

The fee provision may be constructed so that it may be waived. However, it is generally best that fee waivers only be permitted if the fund will not be adversely affected, other than for non-receipt of the redemption fee itself. The fee should not be waived to the extent that there are unrecovered breakage costs, but does not have to be charged in full or in part if it would cause a windfall for the remaining investors.

### – Mandatory or Elective Gates

When the gate threshold is reached, the gate may have a mandatory/automatic trigger or be invoked only at the election/option of the manager. The impact of an automatic gate with the ability of the manager to waive may be the same as a gate that is applied at the discretion of the manager. However, there may be a difference in the investors' perception of the importance of the threshold being reached and on the manager's analysis of its disclosure obligations in so far as the automatic gate requires a positive act by the manager to be waived, while the elective gate requires a positive act by the manager to be imposed.

### – Ambiguous Language – A Pitfall

A gate's wording must be precise. Experience has shown that some are worded, inadvertently or intentionally, so that redemption of "not more than" the gated amount is permitted as opposed to "not less than" the gated amount. Technically, the argument may be made that the "not more than" language provides that once a gate threshold is hit, the manager can limit the amount redeemed to any percentage lower than the threshold, *e.g.*, on a 25-percent gate, the investor could be limited to not redeeming more than 10 percent.

## Part Two:

### Investor Gate or Staggered Redemption Design

An alternative to the fund level gate is the investor level gate. This may also be referred to as a "staggered redemption" (and desirable to the extent the term "gate" has negative connotations). Investors generally do not like gates, due to the potential uncertainty of amounts to be received. Investor gates operate very differently from a fund gate. A fund gate is part of a failsafe mechanism to provide a fund-wide brake on redemptions. The very act of triggering and invoking the gate is viewed as a negative in the industry and may bring about increased redemption requests as investors fear for their ability to get their investments out.

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## Funds may combine fund gates and investor gates.

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The investor gate, in contrast to the fund gate, is part of the ordinary process of redemption. There is no stigma to the fund when an investor is at its redemption limit. In fact it is quite the opposite, as the only way to completely redeem is for an investor to be at its limit for all of the periods over which the complete redemption must be staggered. The following is an example of a typical investor gate and how it applies. An investor gate of 25 percent typically means that for the first redemption period in a sequence, the investor will be limited to redeeming 25 percent of the amount of its investment in the fund.<sup>1</sup> Assuming that the investor would like to redeem in full and has submitted the maximum redemption requests, the investor will be able to redeem 33 1/3 percent of its remaining investment in the second period, 50 percent of its remaining investment in the third period, and 100 percent of the remaining investment in the fourth period (subject to any applicable hold-back or other limitations on redemption, such as side pockets/designated investments). As long as an investor has put in a request to redeem the maximum for a given redemption date, the increasing percentage of the investor gate will continue until the redemption is complete. However, if during a sequence of redemption periods, the redemption request is not for at least the maximum that is redeemable for such period, the investor gate will be reset back down to its starting level. This would be 25 percent in the example above. Investor gates provide certainty and stability without unnecessary stigma. They do not have the problem of diminishing size of the gate, unless drafted that way; this is a less typical formulation, which also requires an investor gate clean-up provision analogous to the fund gate provision. The investor gate also may be applied on an investment by investment basis as opposed to the overall investment.

Redemption fees can also be incorporated to permit redemptions in excess of the maximum redemption amount for a redemption period; provided that the liquidity of the portfolio can handle such increased amounts (*i.e.*, the breakage costs are less than or equal to the redemption fees). The investor gate should also incorporate offsetting investments.

Investor gates may require a new redemption request for each redemption period or may automatically stagger such requests. Automatic staggering is preferable for the investor. This avoids an inadvertent reset of an investor's gate due to the investor failing to submit one of the staggered redemption requests on time.

An investor gate provides the investor with greater predictability of redemptions and greater fund stability, but at the expense of the investor potentially not being able to redeem as much as under a fund gate if other investors are not redeeming.

The key advantages for the manager of an investor gate include (1) greater predictability of redemptions (providing better stability to manage investments of the fund), since each investor must

redeem over a known number of periods; (2) avoiding the negative stigma to the fund of a fund gate being imposed; and (3) reducing the risk of over-concentration in the commingled portfolio of a fund. A potential downside for the manager occurs if all investors were to make substantial redemption requests during the same redemption period. The staggered nature of the requests, result in substantially higher percentages to be redeemed from the fund after each quarter. For example, assume two funds, each with \$100 million; Fund 1 has a fund gate of 25 percent and Fund 2 has an investor gate of 25 percent. The amounts that can be redeemed at the end of each quarterly redemption period are illustrated in the following chart, which assumes redemption requests are 100 percent by all investors in each fund and there is no gain or loss over the year:

Thus, while the Fund 2 investors each had a complete redemption over the course of a year, the Fund 1 investors still have almost one third of their assets remaining after four quarters of redemption. It should be noted that in both cases, redemptions might be suspended and the funds liquidated due to such substantial requests.

Another option when implementing an investor gate is to have no reset of the gate after a redemption date on which the maximum amount permitted to be redeemed was not redeemed. Instead the investor gate is limited to the gate percentage of capital contributions, as adjusted for profits and losses, at all times. This method is considerably less protective of a fund's portfolio than an investor gate with a reset, since each redemption increases the percentage that such investor can redeem of its investment without the redemption being predictable. For example, if an investor has already withdrawn 60 percent of its capital contributions, as adjusted for profits and losses, then, if a 25-percent gate, such investor can redeem 60 percent (25 percent [percentage of investor gate] divided by 40 percent [percentage of capital contributions, as adjusted for profits and losses, remaining]) of its remaining investment on any redemption date. If each investor in such fund had previously redeemed similar amounts over time, then 60 percent of the entire fund could be redeemed at once. Depending on the liquidity of the fund's investments, the lack of a reset could cause a significant problem for the stability of the fund without warning.

### Combining Gates

Funds may combine fund gates and investor gates. These are of two types: those that impose the fund gate and then the investor gate; and those that impose the investor gate and then the fund gate. Where the fund gate is first, the fund gate is a threshold test. Effectively, if the fund gate is triggered, then the investor gate is applied. The investor gate then limits redemptions in a manner other than the *pro rata* application of the fund gate.

An alternative is applying the investor gate and then the fund gate. When investors are seeking to completely redeem, the investor gate percentage effectively increases in each period. If the level of redemptions would rise to a level that would destabilize the fund from an orderly trading or portfolio management perspective,

the fund gate would be imposed performing its typical function as a brake. For example, if the fund gate and the investor gate are both 25 percent per redemption period, then in the first period when there are any redemptions, the investor gate will make it impossible for the fund gate to be hit, *i.e.*, 100 percent of investors making their first redemption request will be limited to 25 percent each, which cannot exceed 25 percent of the fund as a whole. However, in the second redemption period all of the redeeming investors would be permitted to each individually redeem one third of their investment, making the fund gate meaningful at 25 percent. Note, depending on how an investor gate is drafted, the timing of the final redemption may or may not be affected. Unless the fund gate explicitly extends the length of the investor gate by increasing the number of periods remaining, as soon as the fund gate is not applied, an increased proportion, possibly up to 100 percent, of the investor's remaining investment may be liquidated. If the size of the investor gate, including its increasing nature, is suitable for the overall liquidity of the fund's portfolio, then the fund should be constructed with only an investor gate and no fund gate.

Multiple fund gates can be combined. A fund may have a quarterly gate and an annual gate. Combining fund-level gates is generally not recommended. It may cause an incentive to redeem earlier in order to avoid being limited by the longer gate. For example, if a fund has a quarterly gate of 10 percent and an annual gate of 25 percent, investors have an incentive to redeem earlier in the year for fear of not being able to redeem at year-end. This is the same concern discussed in part one of this article regarding the syncing of gates with redemptions dates.

Fund gates are not a necessity, if there are sufficient alternative tools such as an appropriate investor gate. Prior to overlaying a fund gate on top of an investor gate, it is useful to determine whether it is necessary to have a fund gate based on the liquidity of the portfolio, including at times of heavy stress, or the addition of additional liquidity terms such as side pockets/designated investments or liquidating redemption distributions would make the fund gate unnecessary and avoid its stigma. In the case of a fund portfolio that contains largely liquid exchange

traded securities, it would be expected that the only time a gate would have to be used is in the event of an emergency or other extreme circumstance. In such a fund, a manager could opt not to include a fund gate and perhaps just use an investor gate with a suspension provision as a backup for emergencies. The suspension provisions may be complete or partial.

### Suspension

Another alternative to a fund gate is to rely on the ability to suspend redemptions. There are two types of suspensions: total and partial. The suspension of redemptions may be implemented with or without a suspension of net asset value, depending on the operative documents. It may be advantageous for the manager to choose between different types of suspension, since it may be necessary to determine net asset value for purposes of complying with its swap counterparties' requirements, as well as facilitating potential transfers. A complete suspension precludes any investor from receiving any portion of its redemption request.

A partial suspension is an uncommon provision. It is effectively a variable gate. The manager elects to suspend the liquidation of a certain asset or a certain portion of assets, which would be economically prohibitive to liquidate, and permits the redemption of only a portion of the fund. This subjects the investors to an indeterminate gate that is applied for reasons and in amounts that are often determined by the manager and at the manager's sole discretion. The manager's rationale is that the ability to partially suspend benefits the investor, by providing the fund the capability to pay out a portion of the requests, as opposed to paying out none of the requests. The investor's concern is that the manager may elect to partially suspend the fund at a time when it would not completely suspend the fund. In such a situation, the flexibility given to the manager would result in a partially delayed payment to the investor instead of full payment. If a partial suspension would only occur when a full suspension would otherwise be imposed, then a partial suspension may benefit the investor. However, there are better, more accurate

Redemption Period	Fund 1 (Fund Gate)	Fund 2 (Investor Gate)
Quarter 1 Amount Redeemed	\$25 million	\$25 million
Quarter 2 Amount Redeemed	\$18.75 million	\$25 million
Quarter 3 Amount Redeemed	\$14.06 million	\$25 million
Quarter 4 Amount Redeemed	\$10.55 million	\$25 million
Amount Remaining	\$31.64 million	\$0

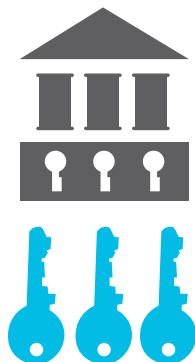
## HEDGE FUND GATES

### FUND GATES



- CAPS AGGREGATE AMOUNT THAT ALL INVESTORS MAY REDEEM
- MAY RESULT IN A LOWER REDEMPTION AMOUNT IF TRIGGERED
- INVESTORS MAY NOT KNOW WHETHER THEY WILL BE ABLE TO WITHDRAW THEIR PERSONAL FUNDS
- NEGATIVE PRESS COVERAGE HAS ATTACHED STIGMA TO FUND GATES

### INVESTOR GATES



- CAPS INDIVIDUAL AMOUNT THAT EACH INVESTOR MAY REDEEM
- MAY RESULT IN A LARGER REDEMPTION AMOUNT IF ALL INVESTORS WISH TO REDEEM LARGE AMOUNTS AT THE SAME TIME
- INVESTORS ARE BETTER ABLE TO PREDICT WHETHER THEY CAN WITHDRAW PERSONAL FUNDS
- VIEWED LESS NEGATIVELY THAN FUND GATES BY INVESTORS

Source: Gates, a Primer • Contributed by David J. Lestz, Counsel, Sidley Austin LLP

and targeted redemption provisions that can be used instead of a partial suspension. Among them is a liquidating redemption distribution provision with regard to certain types of investments.

#### Liquidating Redemption Distributions and Side Pockets/Designated Investments

Other provisions can be used in lieu of gates, including liquidating redemption distributions and side pockets/designated investments. Both of these provisions provide mechanisms whereby the *pro rata* portion of difficult to liquidate or price assets may be allocated specifically to redeeming investors. The redeeming investors will, instead of receiving their entire

redemption request immediately in cash, receive the portion related to the liquid assets in cash and the portion related to the illiquid assets as the underlying illiquid assets are liquidated. This alleviates the concern regarding over-concentration of the remaining investors in the illiquid assets.

**The investor gate, in contrast to the fund gate, is part of the ordinary process of redemption.**

#### Conclusion

Gates are one redemption tool among many. A gate is not required for all funds, but it should not be dismissed just to seemingly enhance redemption liquidity. The design of a gate should take into account the factors discussed in part one of this article. The possible effect of the gate or its invocation on the perception of the fund's viability in the marketplace must be considered and the gate crafted accordingly. In addition, the terms of the gate and its presence may impact the investment decision, both in size of the investment and whether to invest. Careful consideration must be given to these factors to assure the gate is appropriate for the type and size of fund and the anticipated investors.

<sup>1</sup> The amount that can be received in the initial period under a 25 percent investor gate as opposed to a 25 percent fund gate is less, unless the entire fund is being redeemed. However, after the first period, a redeeming investor may benefit by being able to redeem a greater amount in the subsequent periods than if there had been complete redemptions by all investors. If there had not been complete redemption requests, an investor may be able to redeem a greater amount under a fund gate, but with less certainty.

*David J. Lestz is counsel in the New York office of Sidley Austin LLP, and a member of the Investment Funds, Advisers and Derivatives group. He advises and represents clients in domestic and international offerings of hedge funds, funds of funds and commodity pools, and related regulatory matters. He also represents institutional investors in connection with investments in various alternative investment funds. [dlestz@sidley.com](mailto:dlestz@sidley.com)*

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