IOSCO Consultation Report CR01/11: Principles on Suspension of Redemptions in Collective Investment Schemes

1. Introduction

The Hedge Fund Standards Board (HFSB) was set up to act as custodian of the Hedge Fund Standards published by the Hedge Fund Working Group in 2008 and to promote conformity with them. It is also responsible for ensuring that they are updated and refined, as appropriate. Over 100 stakeholders, including hedge fund managers and investors have committed to the HFSB process. The HFSB expects its Hedge Fund Standards to be widely adopted and an increasing number of investors to use the Standards in their due diligence.

The Hedge Fund Standards Board (HFSB) is pleased to respond to the IOSCO Consultation on Principles on Suspension of Redemptions in Collective Investment Schemes (CIS).[1]

It is important to highlight that the HFSB has consulted in the past on similar issues in its Consultation Paper CP1/2009. [2] The findings from that consultation were incorporated in the Hedge Funds Standards in 2010.

2. General observations

The HFSB agrees with the overall assessment in Chapter 2 of the Consultation Report, and in particular with the risk of unfair treatment of investors. The report highlights the potential adverse impact on investor confidence and potential spillover effects that suspension of redemptions can have (p. 6).

- ***It is important to highlight that "<u>not suspending redemptions in instances where fair treatment of investors cannot be guaranteed any more" can be equally damaging</u>: In a distress scenario, non-redeeming investors may fear being left with the illiquid remainders of a portfolio ("bottom of the barrel risk"), while redeeming investors are paid off from the proceeds of the sale of the liquid portion of a portfolio. This situation creates a perverse incentive: All investors will want to "rush to the exit" by redeeming. This creates a classic prisoners' dilemma, with no incentive to hold back individual investors, who are behaving rationally in their own narrow self-interest.***

[1] http://www.iosco.org/library/pubdocs/pdf/IOSCOPD349.pdf
[2] HFSB Consultation section: http://www.hfsb.org/?page=11474

- ***Also, this not only creates runs on individual funds, but can also have "spillover" effects for other similar CIS in a similar manner as the Consultation Report describes spillover effects from suspending redemptions.***

In the context of the market impact assessment (p.6), the Consultation Report raises a sensitive issue: when significant redemptions affect an individual CIS and force it to liquidate its portfolio, this can lead to price decline in the relevant underlying market with further outflows in other CIS. The Consultation Report proposes that it may be appropriate for the responsible entity to consider suspending redemptions in certain limited circumstances, such as run on CIS assets.

This raises a very important question: should decisions about suspensions of redemptions be based on issues relating to fair treatment of investors in the relevant fund as well as "vicious circle scenarios" (i.e. redemptions causing a strong market correction/runs on funds)?

<table>
<tr><td colspan="2" rowspan="2"></td><td colspan="2">Market wide perspective</td></tr>
<tr><td>"no market distress"</td><td>"danger of vicious circle"</td></tr>
<tr><td rowspan="2">Fund specific perspective</td><td>"Fair treatment of investors can be ensured"</td><td>(1)
⇨ No need to restrict redemptions</td><td>(2)
⇨ ??</td></tr>
<tr><td>"Fair treatment of investors cannot be ensured"</td><td>(3)
⇨ Restrictions around redemptions justified</td><td>(4)
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Inclusion of "danger of vicious circle" into the criteria for justifying suspensions of redemptions requires further clarification:

1) Are distress situations realistic, where an individual fund is able to fairly treat his investors (e.g. by liquidating its assets), while at the same time cause distress to other investors (i.e. falling prices, etc)?

2) Are individual fund managers or the funds' governing bodies at all equipped to make judgements on "danger of vicious circles/disorderly markets" when making decisions about suspensions of redemptions in relation to their clients?

3) In a situation where investors could still be treated fairly (e.g. by liquidating the fund), while markets might be affected, does this mean fund managers or the respective fund boards should take action against the best interest of their investors?

4) What impact do such suspensions (on the basis of presumable "vicious circles") have on price formation in the market place?

5) This raises a broader question: is it at all necessary to introduce "vicious circles" as a concept for justifying suspensions?

HFSB recommendation:
The HFSB has stated in the past that where a fund is invested in liquid assets, redemptions should be honoured as long as fair treatment of investors can be ensured, but has not explicitly incorporated market wide assessments (i.e. "vicious circles") in the criteria for imposing restrictions around redemptions. The HFSB would recommend reviewing Chapter 2 to clarify that restrictions of suspensions are only justified when fair treatment of investors cannot be ensured.

3. Observations on the principles

The HFSB broadly agrees with the principles set out in the IOSCO Consultation Report. However, we would like to make the following observations.

- *The inclusion of "fire sale prices" as criteria for defining exceptional circumstances will need further assessment (i.e. what constitutes a "fire sale price"). This is in line with the assessment included in the General Observations of this consultation response in section 2.* ***(3.1)***
- *Conflicts of interests arising in the context of decisions about suspensions of redemptions need to be considered.* ***(3.2)***
- *The HFSB's work on liquidity risk management (in a hedge fund management context) might provide relevant insights for IOSCO on improving understanding and practices in this area.* ***(3.3)***

3.1 Definition of "fire sale" prices

The IOSCO Consultation report sets out an approach for the decision to suspend redemptions (Chapter 3, C: Criteria/reasons for the suspension, a) Exceptional circumstances).

Step one of this approach highlights two criteria to describe the characteristics of exceptional circumstances:

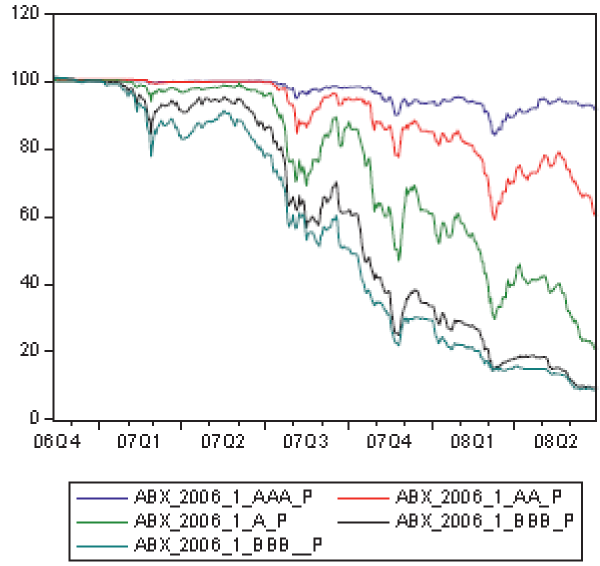
a) Fair and robust valuation of the asset is not possible

b) Asset can only be sold at fire sale prices (in order to meet redemption requests)

The HFSB believes that further clarification is required around the concept of "fire sale prices" and it might be useful to assess what impact "suspensions of redemptions" in such circumstances has on the price formation process.

As seen during past financial crises, strong market corrections can occur (and tend to happen more frequently than some standard models seem to predict) and in many instances, the price corrections are not temporary in nature, but sustainable and thereby justified in hindsight (i.e. when a bubble bursts), with prices ultimately settling at much lower levels. The ABX index, a widely followed index of valuations of US subprime mortgages, provides an example of this (see Illustration 1).

Illustration 1: Time series of ABX prices[3] (for H1/2006 vintage mortgages, for different rating classes)



Source: ECB, http://www.ecb.int/pub/pdf/scpwps/ecbwp1056.pdf p. 35.

Market-based systems usually provide a framework for price discovery, balancing of supply and demand and competition. If it is intended to encourage suspensions of redemptions during times of market price correction, where what is described as "fire price selling" is likely to be occurring, it is important to acknowledge that this affects the price discovery process in the market place and can also reduce liquidity: while the suspension can cushion the drop in market prices, it might also prevent investors from entering the market for fear of overpaying for the asset.

It is obviously very difficult to assess during the actual market correction whether a new price discovered in the market place represents a "fire sale" and potentially only a temporary correction or overreaction of the market, or whether it is reflective of a longer term adjustment of prices. **What should be avoided are the situations when restrictions around redemptions are enacted based on presumable "fire sale prices" even though price discovery is correct and investor redemption requests could actually be honoured.**

HFSB recommendation:

While the HFSB agrees with the first criterion (a) mentioned above, it believes that it is unclear how "fire sale prices" justifying suspensions of redemptions can be defined and distinguished from situations where justified corrections in market prices are underway, and where suspensions of redemptions would not only hurt investors in the fund (who cannot redeem), but will also slowdown the discovery of a new market price where buyers are willing to step in.

A feasible approach could be to restrict exceptional circumstances to criterion (a) [Fair and robust

[3] The ABX index family is based on credit default swaps (CDS) written on US home equity loan (HEL) MBS and track the price of credit insurance of such deals. The indices are traded on price rather than in spread terms (see Illustration 1)

valuation of the asset is not possible, e.g. because of lacking liquidity in the market place]. This could likely include certain “fire sale” scenarios, where fair and robust valuation of the asset is not possible, but not to generalise as all types of “fire sale” scenarios.

3.2 Conflicts of interest

The IOSCO paper refers to the “responsible entity” in charge of determining what is in the best interest of unit-holders when suspending redemptions. In some instances, this might be the fund governing body, in others it might be the managing entity.

From a governance perspective, the HFSB would like to point out potential conflicts of interests, and how they are properly managed / overseen.

Obvious examples of such a conflict are situations where a manager has an incentive to suspend redemptions in order to avoid loss of management fees as a result of redemptions.

Therefore, it might be helpful to identify potential mechanisms, such as independent boards (where investors delegate decision making authorities) vis à vis more rule-based mechanisms (e.g. where the manager is directly in charge of making such decisions).

Proper handling of such situations by the “responsible entity” is crucial in improving investor confidence in asset management and overall capital markets in situations of distress, and thus should not be underestimated.

The Hedge Fund Standards give a strong preference for independent governance models to manage such situations of distress.

3.3 Liquidity risk management

The HFSB agrees that it is important to consider the liquidity of the types of instruments and assets and their consistency with the overall liquidity profile of the open-ended CIS before and during any investment. In this context, the dynamic nature of the liquidity of assets and instruments should be taken into account. As seen during the crisis, liquidity can fluctuate significantly and highly correlate with other factors and events (margin calls, investor redemptions, cancellation of credit lines).

Therefore, the HFSB agrees that further guidelines do help clarify the tools and mechanisms that improve the overall approach to liquidity risk management and would like to highlight its own work in this area, which might be of relevance to IOSCO’s efforts. **The Hedge Fund Standards contain a dedicated section covering “Liquidity Risk Management” (Standard 12) as part of the broader risk management framework, covering the liquidity risk management framework, stress testing, and the inter-linkage with other areas of risk management (i.e. market risk). Appendix A includes the relevant section on liquidity risk management.**

The HFSB would be happy to work more closely with IOSCO on issues relating to liquidity risk management and other areas where common principles for asset managers are required.

Appendix A

Liquidity risk management – Standards and Guidance [12]

- **A hedge fund manager should develop a liquidity management framework, the primary role of which is to limit the risk that the liquidity profile of the fund's investments does not align with the fund's obligations.**

  This could include forecasting the liquidity position of the fund and tracking liquidity measures (e.g. ratios such as "available cash/Value-at-Risk") which allow the hedge fund manager to assess the probable development of the fund's liquidity position relative to the portfolio's inherent risk.

  The nature of this framework would depend on the categories of assets and leverage profile of the hedge fund.

- **A hedge fund manager should regularly conduct stress testing and scenario analysis of the fund's liquidity position.**

  Potential stress events could include:

  – margin calls due to sudden severe market shocks (e.g. significant equity price falls);

  – reduction in liquidity in certain market segments relevant to the fund;

  – a sudden increase in collateral requirements for funding positions (thereby reducing assets available for sale to meet liquidity needs);

  – investor redemptions (as per the fund's redemption policies) (where relevant34); and

  – cancellation of credit lines (as per notice periods agreed between the fund and Counterparties, such as prime brokers).

  The stress testing/scenario analysis should also take account of the impact of market risk stresses on the liquidity position of the fund (see following market risk management standard).

  It has been widely found that in stress situations unexpected correlations can appear. Hedge funds have been faced with sudden liquidation challenges due in part or in whole to rapid market movements, for example in currencies, commodities or equities.

Source: Hedge Fund Standards, http://www.hfsb.org/?section=11502