HFSB Consultation Paper (CP1/2009): Hedge Fund Redemptions

Overview

The HFSB invites comments on this Consultation Paper 1/2009 (CP1/2009). Comments should be submitted by **18 September 2009**. This CP contains a number of questions for respondents, which can be submitted electronically (Word, pdf-document) to Thomas.Deinet@hfsb.org. Alternatively, please send comments in writing to:

Hedge Fund Standards Board
CP1/2009 (Redemptions)
2nd Floor
167 Fleet Street
London EC4A 2EA

It is the HFSB's policy to make all responses to consultations available for public inspection unless the respondent requests otherwise. A standard confidentiality statement in an e-mail message will not be regarded as a request for non-disclosure.

Copies of this CP are downloadable from the HFSB website, www.hfsb.org.

Starting point and stakeholder concerns

The hedge fund industry has recently faced significant investor redemptions, coinciding with an overall drop in market values, reduced availability of credit/leverage from Prime Brokers, and reduced liquidity in certain market segments such as emerging markets, small cap and convertibles. This has put significant strain on the liquidity position of certain funds, and results in forced selling into depressed markets, thereby driving valuations even lower.

Many market participants have expressed their concerns around this topic to the Hedge Fund Standards Board ("HFSB"), as summarised in Appendix 1.

From the Hedge Fund Standard Board's perspective, these concerns give rise to two questions:

1. Are there systemic concerns (e.g., additional stress on the financial system) that need to be addressed?

2. Should the handling of redemptions be addressed by the HFSB's best practice standards ("Standards") and would this help mitigate some of the systemic concerns?

1. Systemic concerns

Market-based systems usually provide a framework for price discovery, balancing of supply and demand, competition, and in particular, penalising market participants who do not meet their client's (i.e., investor's) expectations. The hedge fund industry is a good example of such a market based system, with hundreds of funds closing down every year and hundreds of new ones emerging – a "Darwinian" process driven primarily by fund/manager performance.

However, three major factors arise in the current market environment, because they create perverse incentives, that work against the long term efficiency of the industry:

a) Investors' search for liquidity disproportionally affects managers who are more inclined to provide liquidity ;
b) Long-term investors might be discriminated against if they do not redeem ;
c) Pre-emptive redemptions by investors increase the pressure on funds to remain excessively liquid and disadvantage long-term investors.

a) Perverse incentives for manager behaviour

Funds providing liquidity (e.g. not imposing gates/suspending redemptions) bear the brunt of the current investor preference for liquidity and might eventually go out of business (even despite good performance), while managers imposing gates/suspending redemptions to protect the fund from selling assets at distressed prices might survive (again, regardless of their actual performance).

Interestingly, both types of manager argue that they act in the best interest of investors: the former argue that honouring their investors' contractually agreed redemption rights is their fiduciary duty and makes them a more trustworthy manager in the long run, helping prevent further reputational damage to the hedge fund industry as a whole. The latter, however, argue that gates or suspension of redemptions help to protect investors and, in particular, ensure that all investors are treated fairly in instances where the fund is not able to sell off assets in an orderly manner to honour the redemption requests in time.

Ultimately, both types of managers are right in their own way, and for example in the light of FSA's principles, both approaches have merit. Both honour "customers' interests"[1] , but it may be the case that the choice managers make will be driven by their own commercial interests.

b) "Bottom of the barrel risk"

In the current environment, non-redeeming investors may fear being left with the illiquid remainders of a portfolio, while redeeming investors are paid off from the proceeds of the sale of the liquid portions of a portfolio. This situation again provides a perverse incentive: investors will want to "rush to the exit" by redeeming. This creates the classic prisoners' dilemma, with no incentive to hold back individual investors, who are behaving rationally in their own narrow self-

[1] Principle #6

interest. Long term investors, who should be the mainstay of the industry, may be penalized for their loyalty.

c) Pre-emptive redemptions

Some investors intending to remain invested may, however, want to secure the option to redeem at short notice. With redemption mechanisms requiring notice periods prior to payment , some investors have been observed filing pre-emptive redemption notices, and ultimately revoking the notice and staying invested. The manager is nevertheless forced to build a liquidity cushion by selling off assets. If the investor ultimately stays in the fund, the direct and indirect costs (transaction cost, forgone performance, ...) of the liquidity cushion are borne by all investors and put those who have not secured the "option to redeem" at a disadvantage. Again, as long as there is no cost associated with this option, it might be rational for investors to behave in this manner, although this obviously constitutes harmful behaviour. Ultimately, if all investors behaved the same way, the hedge fund would not be in a position to manage the assets effectively, leading all investors to redeem.

Assessment of externalities

These concerns illustrate several externalities (here: negative externalities, i.e., behaviour, that causes an external cost to a third party who is not part of the economic transaction).

- Some managers will go out of business because others have restricted redemptions on their own funds (a)
- Potential reputational damage to the industry as a whole (a)
- Redemptions of some investors causing other investors to redeem as well (b)
- The cost of pre-emptive redemptions that are ultimately revoked is borne by those who did not intend to redeem (c)

Beyond these obvious externalities, there is also a broader question which hints at a much wider negative externality: if incentives are set in a destructive manner as delineated above, is there a risk that the hedge fund industry will shrink more than otherwise would be the case, to the detriment of financial markets as a whole, and adding to the risk of further fire sales of assets?

Therefore, it is important to assess to what extent these externalities can gather damaging momentum causing further harm to capital markets, and to what extent the risks related to massive redemptions can be mitigated.

How to break the circle

There is a spectrum of approaches for addressing these issues, ranging from commercial, market driven approaches to regulatory intervention. The HFSB believes that there can be a market driven approach to "solving" these externalities, ie. by internalising them. The subsequent chapter assesses the mechanisms for "internalising" the externalities described above, and looks at possible behavioural best practice that could be proposed to market participants to mitigate these concerns.

Consultation question:

1. Do you agree with the analysis of systemic concerns?

2. Best practice assessment

The following section provides an assessment of the issues/concerns raised in the light of FSA's principles, and implications for best practice. In particular, we have developed hypotheses for discussion around potential best practice standards that could arise in this context.

Hypothesis 1: Where a fund is invested in assets which have become, or are inherently, illiquid, restrictions around redemptions are appropriate to ensure fair treatment of all investors.

- The opposite would clearly have devastating effects. If investors knew that there is the slightest risk of unfair treatment (being left with the bottom of the barrel), they would wish to redeem immediately, causing a run on the fund.
- It is important that funds dealing in illiquid markets (or markets where there is risk of a liquidity dry up) state upfront these inherent risks, highlight circumstances in which normal redemption mechanics might not apply or may be suspended, and how such redemption restrictions would be enacted (investor involvements, flexibility of fund directors to enact restrictions, handling of fees, etc.) [see recommendations in section 3].

Hypothesis 2: Where a fund is invested in liquid assets, redemptions should be honoured as long as fair treatment of investors can be ensured.

- The opposite would be damaging, at least for individual funds/managers. Investors might choose to no longer invest with managers who have a track record of suspending redemptions for no reason. Thereby, the HFSB believes that internalisation (ie penalising those who do not act in the best interests of their clients) actually works in the medium term. Unfortunately, some managers who behave properly might go out of business in the short run, and therefore, some negative externality will remain.
- However, liquid managers might wish to consider implementing measures to secure a more stable capital base, which might include share classes with longer lock ups for investors in return for lower fees. Clearly, this needs to be specified upfront and disclosed to all investors so that they are in a position to choose from the various options.

Hypothesis 3: A fee should be applied for revoking redemption notices, which reflects the cost of liquidity provision and foregone performance, payable to the fund by the investor.

- If there is no cost associated with the option to redeem, investors might always want to secure this option in times of uncertainty / distress in the future, thereby destroying the ability of the manager to properly manage the fund. This could be an optional measure implemented only when there is (risk of) abuse.
- Obviously, this appears counterintuitive in times where investors (and their monies) are most needed. However, the measure ensures that long-term investors are protected.

These proposed behavioural best practices are designed to enhance confidence and make funds' behaviour more predictable. It will not prevent redemptions from investors who want to redeem, but will enhance confidence of those investors who would like to remain invested, and those who intend to invest.

Consultation question:

2. Do you agree with the best practice implications highlighted in the three hypotheses above?

3. Best practice recommendations

In an ideal world, the contractually agreed redemption terms should be matched by the liquidity of underlying assets. This might result in funds investing in illiquid assets exhibiting longer lock up periods (eg similar to private equity investments) while liquid funds can have more liquid structures (eg monthly liquidity).

However, in reality, liquidity in markets fluctuates, and otherwise liquid segments of the markets can suddenly dry up, making it necessary to alter the redemption mechanism. The HFSB acknowledges that there might be a wide spectrum of investor preferences regarding the handling of such alterations. However, in all instances, fairness should be an important underlying norm, as stated in hypothesis 1 above**.**

The HFSB also believes that predictability of fund behaviour in times of liquidity distress is a key element in ensuring fairness. This is best achieved by upfront disclosure of how a fund might behave during such distress and adequate governance mechanisms.

Hedge Fund Managers should encourage the Fund Governing Body to disclose the following in the fund's prospectus :

Overview of mechanisms to restrict redemptions

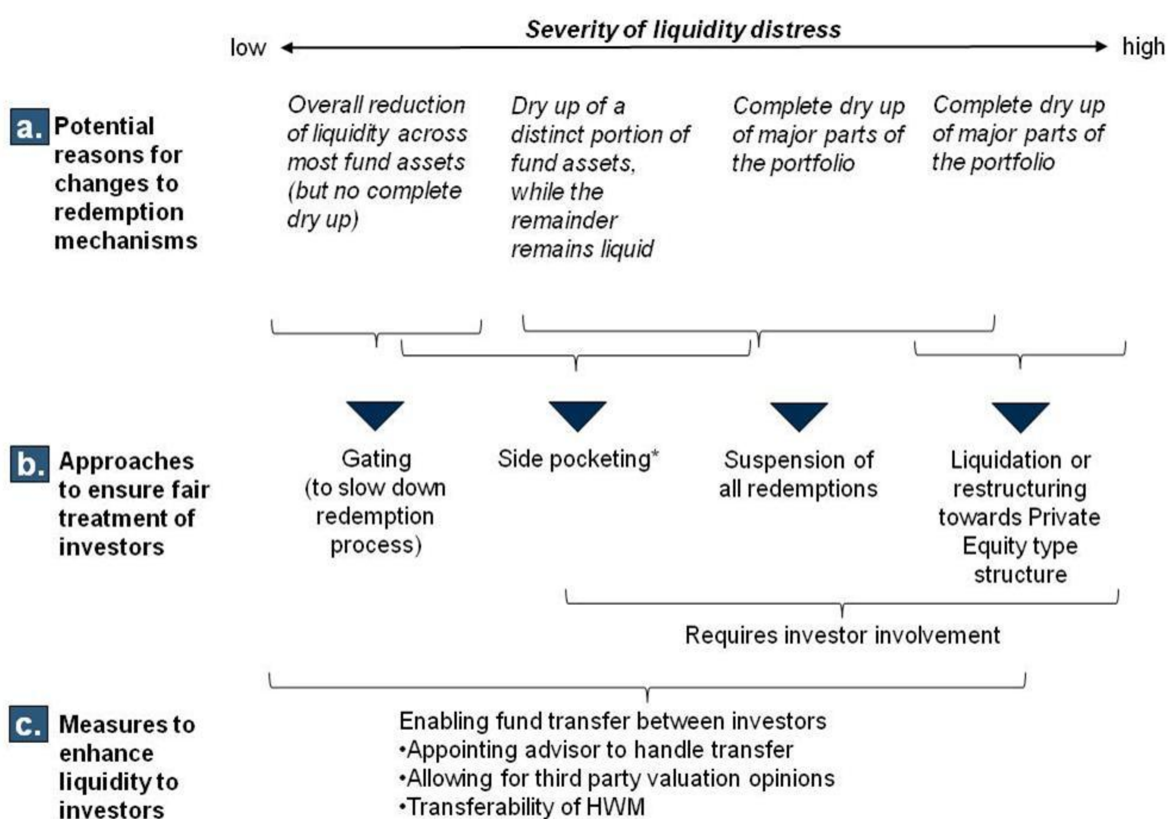
Mechanism	How it works	Additional considerations
Gating	A gate provision is a restriction placed on a hedge fund limiting the amount of withdrawals from the fund during a redemption period, eg by limiting withdrawals to a certain percentage of fund AUM for each period.	• Upfront disclosure of the gating level
Suspension of redemptions	Complete suspension of redemptions, no investor can withdraw.	• This measure is obviously at the more "draconian" end of the spectrum, requiring a sound assessment that it is in the best interest of investors (eg in comparison to other measures).
Side pocketing	The fund is split into a liquid and an illiquid share class, with all investors holding a stake in both share classes. Redemptions can continue on the liquid part (though a gate could be imposed on the liquid share class), while redemptions are suspended on the illiquid shares.	• Side pockets can become complex to administer, in particular if multiple side pockets surface over time. • Calculation of fees need to be carefully managed, ie ensuring that fees are separately calculated for the liquid and the illiquid share classes. • Investors might seek to negotiate fee rebates on side pocketed assets.[2]

[2] This is a quid pro quo situation: The manager forgoes part of the fee in return for a longer lock up.

Liquidation	If redemption requests exceed a certain percentage of total fund AUM, fund directors might decide that it is best to unwind the entire fund.	• Fund directors might wish to consult with investors to let them vote on how to handle the unwinding process. • In specie redemption usually not considered a favourable option by investors.

The approach described above relies primarily on disclosure, rather than prescription, providing sufficient leeway for fund boards to determine according to their funds' individual circumstances the best course of action. There is no single best way for funds to act, however, and the severity of the liquidity mismatch might determine to some extent the required measures by the Fund Governing Body, as illustrated below.

Illustration of approaches to suspend redemptions as a function of severity of distress



Beyond illustrating the spectrum of options available in situations of distress, this also highlights the complexity of decisions that fund governing bodies face in such instances. Undoubtedly, a key prerequisite for this is a functioning governance structure with independent decision making capacity.

4. Proposal to change the Hedge Fund Standards

The Hedge Fund Standards Board proposes to enhance the existing Disclosure Standards and Guidance in relation to Commercial Terms [Standard 2]. As illustrated in the following table, it is the Guidance in relation to "exit terms" that has been enhanced to reflect the proposed additional disclosures (changes/additions are marked up in track changes below).

Proposed new disclosure Standards and Guidance

[2] Commercial Terms Disclosure	
• **A hedge fund manager should do what it reasonably can to enable and encourage the fund governing body to disclose the commercial terms applicable to a particular hedge fund in sufficient detail and with sufficient prominence (taking into account the identity and sophistication of potential investors) in the fund's offering documents.**	(as is)
○ fees and expenses (...)	(as is)
○ termination rights (...)	(as is)
○ exit terms (in the case of open ended funds) ▪ the period of notice investors are required to give to redeem their investment in the fund; ▪ details of any redemption penalties (including any fee or penalty, such as the resetting of high watermarks, applicable where redemption requests are revoked); ▪ any "lock-up" periods during which the investor will be unable to redeem its investment in the fund and any limits on the extent of redemptions on any redemption date (i.e. redemption "gates"); and ▪ circumstances in which normal redemption mechanics might not apply or may be suspended, if any – these could include, amongst other things: • a significant reduction in the liquidity of the fund's underlying assets; and • distress of one or more of the fund's counterparties (including its prime broker(s)) leading to uncertainty as to the value of OTC contracts or access to / ownership of rehypothecated assets. ▪ Details of any other measures which may be considered by the fund governing body in circumstances where normal redemption mechanics might not apply or may be suspended – for example: ○ fund level gating, investor level gating, lock-ups, suspension of redemptions, penalties for revoking redemption requests *(to the extent that the fund's constitutional documents do not already provide for such mechanisms)* ○ (synthetic) side pocketing ○ restructuring the fund to incentivise investors to accept, or switch to an alternative share class offering, reduced liquidity (for example in exchange for lower fees) • a clear indication as to whether, and in what circumstances, any changes to liquidity terms would require shareholder consent/consultation; ▪ measures to enhance liquidity at the fund level (eg facilitating transfers of shares/units in the fund) while redemption restrictions continue.	(enhanced)

• **A hedge fund manager should do what it reasonably can to enable and encourage the fund governing body to disclose any material changes to such commercial terms to investors.**	(as is)
(...)	(as is)

The HFSB would like to seek feedback on the following consultation question:

Consultation question:

3. Do you agree that issues in relation to redemptions should be addressed in the HFSB Standards?

4. Do you agree that the disclosure mechanism is the best way to address such issues?

5. Do you agree with the proposed amendments to the Standards?

Appendix 1: Stakeholder concerns

Stakeholder	Concerns
Investors	*Non redeeming long term investors are concerned about being stuck with the illiquid "bottom of the barrel".*
	Some managers/boards give preference to some investors, allowing for queue jumping, selective application of notice periods...
	Some Hedge Fund Managers have been overly optimistic regarding the liquidity they have promised to investors.
	Some FoHF add to the asset liability mismatch by promising liquidity terms that are not matched by the underlying funds' liquidity terms.
	A manager has suspended a fund without giving a proper explanation.
	Some managers do not have adequate control structures in place, (e.g., independent boards capable of dealing with and understanding the issues raised).
	Prospectuses allow for little or no consultation with investors on major issues.
	Most prospectuses allow for managers to suspend or to compulsorily redeem investors for a number of reasonable reasons and "for no reason" and this cannot possibly be best practice.
	There should be independent administration with no manager involvement in pricing unless disclosed to investors.
	Funds should have a minimum standard of reporting and updates to clients, even in markets such as these.
	Sometimes, suspensions of redemptions and gates serve the manager rather than the investors, since the ultimate purpose is to preserve assets rather than actually protecting investors/ensuring fair treatment.
	The current market dislocation with a strong investor preference for liquidity can have systemic impact, leading to forced sales and a dangerous downward spiral in asset prices for all risky assets.
Managers	*Managers who provide liquidity are treated like the ATM of the industry, and might not survive, while those putting in place gates might ultimately survive.*
Investors/ Managers	*Investors put in pre-emptive redemptions, although they do not intend to redeem, thereby forcing funds to increase liquidity levels (at the expense of performance), hurting all other non redeeming investors.*