Principles on Suspensions of Redemptions in Collective Investment Schemes

Final Report

TECHNICAL COMMITTEE
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Chapter 1 - Introduction

In light of the recent developments, where some open-ended collective investment schemes (CIS) or CIS management companies (CIS Operators) were unable to meet redemption requirements, the Technical Committee Standing Committee on Investment Management (TCSC5) decided to investigate whether it should focus on issues pertaining to the suspension of redemptions by CIS responsible entities (as such terms are defined in this paper). In July 2009, TCSC5 circulated an internal questionnaire to its member jurisdictions to assess whether it would be appropriate to develop principles or guidelines in this area and, if so, understand how different jurisdictions' regulatory regimes address the suspension of redemptions by open-ended CIS responsible entities. In April 2010, the questionnaire was additionally submitted to Emerging Market Committee (EMC) members.

The responses to the questionnaire highlighted the global importance of the issue and confirmed that it would be appropriate for TCSC5 to develop principles in this area. With respect to TCSC5 members, all 19 respondents to the questionnaire, except one[1] have had to deal with suspensions of redemptions. In the case of EMC members, 11 out of 19 respondents experienced suspensions. However, differences in experience exist, in particular, regarding the length of the suspension periods, which vary between a few days to years. Overall, various open-ended CIS types were affected, in particular real-estate funds, money market funds, bond funds and funds of funds. The causes of suspensions were mainly the closure of specific stock exchanges and markets or the illiquidity of investments including valuation difficulties and significant redemptions. Although suspensions turned out to be a global event, the experience has shown that the number of suspended CIS remained a rather small fraction of the overall market and spillover effects, which are one of the risks suspensions may entail, did not occur widely in the CIS market.

The responses to the questionnaire showed that members' regulations addressing liquidity and suspensions of redemptions varied across jurisdictions. The heterogeneous requirements become obvious in particular in the area of the criteria for the suspensions, liquidity requirements and disclosure to investors (pre-sale and ex-post). While some jurisdictions impose very specific liquidity limits, others have rather sparse requirements concerning the management of liquidity risks.[2] While some jurisdictions provide responsible entities with discretion to suspend redemptions, others require prior approval from the competent authority.

Moreover, some members have adopted specific provisions that limit redemption rights to deal with liquidity problems, e.g. the creation of 'side pockets' or the setting up of *gates*.

As a result, TCSC5 received a formal mandate in January 2010 to develop, if appropriate, principles or guidelines addressing the suspension of redemptions by responsible entities of open-ended CIS. Accordingly, TCSC5 established a working group to develop appropriate principles or guidelines.

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1 However, in this jurisdiction, CIS also faced liquidity problems and high redemption requests but dealt with these issues by imposing a levy/discount, see Chapter 4 (c) vi c).

2 TCSC5 has initiated a review of liquidity risk management policies and practices at funds and received the IOSCO Technical Committee's (TC) approval for a formal mandate to assess the appropriateness of developing additional guidelines on the aspects and tools which should be considered in an appropriate liquidity risk management process.

On this basis, the working group has thoroughly discussed these issues and has developed principles regarding the suspension of redemptions for responsible entities of open-ended CIS. The principles cover generally all types of open-ended CIS, i.e. all CIS which offer a continuous redemption right. Moreover, with a view to the risks of suspensions, the principles cover open-ended CIS irrespective of the type of investor to which they are offered, i.e. institutional or retail investors. However, not all principles would necessarily be appropriate for, or apply to, specific non-retail CIS which are not offered to the public and are not subject to approval/registration but instead are subject to specific rules under their national applicable law and regulation (notably as regards their structure, investments, operation, marketing).

The aim of this report is to outline principles against which both the industry and regulators can assess the quality of regulation and industry practices concerning suspensions of redemptions. Generally, these principles reflect a level of common approach and are a practical guide for regulators and industry practitioners.

The principles are addressed to the entity/entities responsible for the overall operation of the CIS and in particular its compliance with the legal/regulatory framework in the respective jurisdiction and thus for the implementation of the principles (**the responsible entity**). The delegation of activities may not be used to circumvent the principles. In fact, there should be compliance with the principles, whether activities are performed directly or through a third party. The principles are based on the CIS responsible entities' basic duty to manage CIS liquidity on an on-going basis so as to avoid suspensions to the extent possible.

Although addressing the responsible entities, the principles do not provide direct applicable standards to firms. As stated above, the principles need to be implemented and respected by the jurisdictions. They obviously have to be transposed within the context of the specific legal structures prevailing in each jurisdiction. Hence, the implementation of the principles may vary from jurisdiction to jurisdiction, depending on local conditions and circumstances.

Chapter 2 Risk of Suspensions

Direct impact on the investor

The redemption of units is a fundamental right of investors in open-ended CIS. Investors in open-ended CIS expect to be able to redeem on a regular and continuous basis. If the risks of the CIS product or the possibility of the suspension are not adequately disclosed to the investor there may be heightened regulatory concerns. Suspensions of redemptions prevent investors from having access to their money. This can denote serious consequences for retail investors, particularly, if they are not prepared for the possibility of a suspension. Moreover, if institutional investors or, in particular, another CIS is significantly invested in a suspended CIS, the suspension directly impacts this CIS and leads to further liquidity or pricing issues throughout the related market(s).

Also, in the absence of relevant rules, suspensions may be carried out in non-satisfactory conditions leading to, for example, an unequal treatment of investors. For instance, where certain investors are informed before others of the intention to suspend and rush to request the redemption of their units before the suspension becomes effective.[3]

Confidence and Reputation

The suspension may not only directly impact the investor but, depending upon the scale of the CIS, also may have indirect macroeconomic or market-wide implications.

Suspension generally has an adverse impact on investor confidence. This may cause spillover effects. The fact of suspension in one CIS, or a small group of CIS, increases concerns about further suspensions and may thus lead to disinvestments/withdrawals in other CIS possibly causing further CIS suspensions.

Since confidence is crucial for the stability of the financial systems, it is possible that, in the case of a poor information/disclosure policy, the loss of investor confidence not only impacts the CIS industry but also affects other parts of the financial industry. For example, investors may abstain from investing in other financial investments due to a general loss of trust in the financial system.

The suspension may also impact the reputation of the CIS, the responsible entity and if different the CIS Manager or Operator. The suspension may be seen by investors as a major problem within the CIS and/or its management, and could lead to a run on the CIS once the redemption suspension is lifted. In this case, suspension not only temporarily affects the CIS but may lead to problems within the responsible entity in the long run (e.g. reputational impact). Moreover, if the responsible entity is part of a group, for example, an affiliate of another financial institution the reputational loss may also impact the other group members.

Market impact

As mentioned above, the recognition of a suspension in one or more CIS could lead to extraordinary withdrawals in further CIS. These withdrawals may lead to liquidity problems

[3] Such a practice is not permitted.

within the CIS forcing it to sell assets. A forced sale may, if the CIS is large relative to a particular market or sector, stress the market and lead to further price declines. Such price declines may be reflected in lower CIS prices possibly causing further withdrawals and thus possibly ending in a *vicious circle scenario* (outflows - fire sales – poor performance – outflows). As a result, it may be appropriate for the responsible entity to consider suspending redemptions in certain limited circumstances, such as a run on CIS assets. It should be stressed that such a suspension of redemptions could also exacerbate market uncertainty and cause unit-holders/shareholders[4] in other CIS to redeem, fearing that more CIS will suspend redemptions. This could have a major impact on the economic sector(s) concerned.

Impact on counterparties

Liquidity problems due to extraordinary withdrawals caused by significant suspensions of other CIS (but also liquidity problems in general) may not only prevent CIS from meeting redemptions but also other payment obligations (e.g., margin calls). Liquidity problems therefore not only impact investors but also may impact counterparties.

[4] For brevity, the term unit-holder will be used hereafter.

Chapter 3 Principles

The principles are structured according to the time frame of a suspension. Thus, this chapter starts with principles on procedures for liquidity management that should be implemented to mitigate the risk of suspension owing to a lack of liquidity. Thereafter, the chapter covers principles with regard to suspension events and the process for the decision to suspend. Subsequently, the principles address the time during the suspension (once decided) and its ending. Finally, the chapter includes some examples of alternative measures used in certain jurisdictions to deal with illiquidity. On this basis, the principles chapter is divided into six subsections:

(a) Management of liquidity risk;
(b) Ex-ante disclosure to investors;
(c) Criteria/Reasons for the suspension;
(d) Decision to suspend;
(e) During the suspension; and
(f) Examples of alternative measures to deal with illiquidity in certain jurisdictions.

A. Management of liquidity risk

Principle 1
The responsible entity should ensure that the degree of liquidity of the open-ended CIS it manages allows it in general to meet redemption obligations and other liabilities.

The maintenance of adequate liquidity in open-ended CIS is fundamental in order to ensure that suspensions of redemptions are avoided. The redemption frequency (dealing frequency) of the CIS should reflect the overall liquidity of the CIS's portfolio and vice versa.

Some jurisdictions address this by having an explicit definition of liquidity and setting requirements on the amount of liquidity (as percentage of net asset value (NAV)) to be held in the portfolio of a CIS. Other jurisdictions deal with liquidity on a more principle-based regime by imposing requirements upon CIS Managers or if different upon responsible entities. However, in any case, the degree of the portfolio liquidity should be appropriate and in accordance with the redemption obligations (as provided in the CIS prospectus and as the case may be, in its constitutive documents). Although the borrowing of the necessary cash can be used to facilitate redemption requests, the routine use of borrowing is not an appropriate way to manage the CIS liquidity risk. When managing the liquidity of a CIS, the responsible entity should also consider extreme liquidity circumstances, i.e. shortages of liquidity of assets, global and/or market events and atypical redemption requests. Nevertheless, this principle does not prohibit the responsible entity from suspending redemptions in exceptional circumstances as described below.

Besides the consideration of redemption obligations, the liquidity of the CIS must also be appropriate to deal with other liabilities or payment commitments which result for example from margin calls or collateral requirements for derivative positions.

Principle 2
Before and during any investment, the responsible entity should consider the liquidity of the types of instruments and assets and its consistency with the overall liquidity profile of the

open-ended CIS. For this purpose, the responsible entity should establish, implement and maintain an appropriate liquidity management policy and process.

To ensure adequate portfolio liquidity the responsible entity should consider the liquidity of the instruments and assets and their effect on the overall liquidity of the whole CIS portfolio before and during the investment into such instruments/assets. The responsible entity should only invest in instruments/assets if this investment does not compromise the ability of the CIS to comply with its redemption obligations or liabilities. Some jurisdictions also deal with this issue by implementing eligibility criteria with regard to the liquidity of financial instruments/assets for open-ended CIS.

In order to ensure ongoing compliance with redemption obligations and liabilities, the responsible entity should establish, implement and maintain an appropriate and proportionate liquidity risk management policy and process, which could be part of the overall risk management arrangements[5].

B. Ex-ante disclosure to investors

Principle 3
The responsible entity should clearly disclose the ability to suspend redemptions in exceptional circumstances to investors prior to their investment into the CIS.

CIS investors should be aware of the risk of the suspension of redemptions prior to their investment in open-ended CIS. Information should be available regarding the possibility that their right to redeem may be suspended in exceptional circumstances. Therefore, the CIS constitutional documents and/or prospectus should clearly disclose that redemptions may be suspended in exceptional circumstances. In jurisdictions where the responsible entity has discretion to suspend and/or the national law does not contain a definition of exceptional circumstances, it is recommended not to define in the CIS documentation the terms "exceptional circumstances" specifically on the grounds that such a definition would in practice inevitably become out of date, or exclude circumstances which might be considered exceptional in the future. Instead, it is recommended to use non-exhaustive examples of what might constitute "exceptional circumstances" (e.g., exchange closures).

C. Criteria/Reasons for the suspension

The Technical Committee Statements on *Suspending Redemptions: A Case-Study from 11 September 2001 and General Principles*[6] from October 2002 describes as criteria of a suspension the "exceptional circumstances". In detail, the report states: "Generally, suspensions may be justified only in exceptional circumstances where fair valuation of CIS interests is difficult or impossible to carry out. Emergency situations may also mean that CIS assets cannot be readily disposed of by a CIS so that the CIS cannot meet redemption

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5 The IOSCO TCSC5 currently develops guidelines on the aspects and tools which should be considered in an appropriate liquidity risk management process.

6 See *Suspending Redemptions: A Case-Study from 11 September 2001 and General Principles*, Statement of the Technical Committee of IOSCO, November 2002, available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD135.pdf.

requests and hence a redemption suspension may be justified. In most cases, if circumstances are severe enough to justify a suspension of redemptions, then purchases should also be suspended."

Principle 4
Suspension of redemptions by the responsible entity may be justified only a) if permitted by law and in exceptional circumstances provided such suspension is exclusively in the best interest of unit-holders within the CIS, or b) if the suspension is required by law, regulation or regulators.

The decision to suspend is a two step approach.

a) Exceptional circumstances and best interest of unit-holders

i) Exceptional circumstances

First, suspensions are only justified in exceptional circumstances. Generally, these suspensions should be temporary situations. Moreover, exceptional circumstances are rare, such as where fair and robust valuation of the assets (e.g. because of lacking liquidity in the market place which could include certain *fire sale* scenarios), in which the open-ended CIS is invested, is not possible.

Possible reasons for suspension of redemptions are indicated below, however, this is not meant to define an exhaustive list. In any case, the responsible entity should be able to demonstrate that circumstances are exceptional.

Market failures, exchange closures

Regulators and the responsible entity may consider that exceptional circumstances occur when markets are affected by unexpected events which impact the functioning of exchanges or the regular course of transactions. In such cases, it might be impossible to price assets accurately or to regularly honour redemption requests and pay the related redemption proceeds. If a significant proportion of assets in the CIS is affected such circumstances will likely justify a suspension. If only a small proportion of assets is affected and fair valuation is possible, a suspension may not generally be justified (provided the equal treatment of investors can still be ensured). Such unexpected events could be also related to political, economic, military, monetary or other emergencies.

Operational issues

Exceptional circumstances can also be caused by unpredictable operational problems and technical failures (e.g. a black out). Those operational problems could temporarily hamper transactions or affect the valuation of the assets. Also the failure of a key third party that acts for the CIS can impose operational problems.

However, such cases can only be considered as exceptional circumstances if they are reasonably unpredictable and occur in spite of appropriate diligence of third parties, adequate and effective disaster recovery procedures and systems and contingency plans for such cases. Otherwise poor management as described below would be the reason for the suspension, rather than unpredictable circumstances.

Liquidity issues

The responsible entity is responsible for managing the open-ended CIS so that units can be redeemed and thus should have in place and maintain sound liquidity management arrangements to meet that obligation (see Principles 1 and 2). A suspension which arises as a result of poor liquidity management within a CIS is generally not acceptable. Suspension as a result of a lack of liquidity should therefore only be a last resort in cases where despite appropriate liquidity management the CIS has to face unforeseeable liquidity issues. In such a case the responsible entity must carefully decide whether, in the interest of protecting investors, dealings in the CIS should be suspended to stop a spiral (vicious circle scenario) as mentioned under Section 2.

Poor Management

Nevertheless, it should be mentioned, that it may be reasonable to suspend redemptions when facing *operational or liquidity issues*, although the reason for the suspension is poor management rather than unpredictable circumstances, if this is in the best interest of the investors. In such a case the competent authority could take measures and consider exercising their powers according to the national law, such as imposing sanctions or penalties against the persons responsible for the infringement of rules.

Other events

There may be other events such as natural disasters or catastrophes, which make it impossible to value, or dispose of and obtain payment for all or some of the CIS' property.

ii) Best interest of investors

Second, it must be clear, that the suspension is exclusively in the best interest of the unit-holders collectively. The responsible entity should only suspend redemptions when it is in the interest of unit-holders and when the fair and equal treatment of incoming, ongoing and outgoing investors is maintained.

b) Suspension required by law, regulation or regulators

Notwithstanding, national law, regulation or the regulators itself may require in specific circumstances the suspension of redemptions.

D. Decision to suspend

Principle 5
The responsible entity should have the operational capability to suspend redemptions in an orderly and efficient manner.

a) Implementation of processes in advance

In advance of any suspension event, the responsible entity should implement a decision making process and draw up plans/processes for potential suspension events. Thus, to prepare for the possibility of a suspension, the responsible entity should already have in place

processes and procedures to react immediately in the case of events as described above (emergency plan). Such emergency plans could in advance of a potential suspension event set out the personnel within the responsible entity to be involved in making the decision to suspend and their roles.

Emergency plans should also describe interactions and communication channels with relevant third parties, e.g. the depositary and the competent authority as well as intermediaries or distributors.

Moreover, procedures should describe potential avenues that probably can avoid a suspension as well as objective criteria for reaching the decision to suspend.

The notification procedure to the competent authority could also be specified. Moreover, as one of the key considerations is putting in place an effective communication strategy targeting investors, it will be useful to have a detailed communication plan in place. In addition to contacting investors, plans for the information of intermediaries should be specified to ensure their immediate action.

The responsible entity should also be prepared to deal with queries from investors or other parties that might have to intervene after a suspension.

b) When a suspension event arises

Where a responsible entity arrives at the point to consider a suspension, the responsible entity should thoroughly analyse the situation. Such an assessment may require expert analysis (e.g. external legal counsel) and should therefore involve all relevant persons and relevant internal controls. Independent oversight should be implemented to avoid conflicts of interests.

Some jurisdictions require the prior agreement of the depositary and/or the prior agreement, prior approval or pre-notification of the competent authority. In other jurisdictions, where the responsible entity has discretion to decide a suspension, in any case, an early engagement with the depositary and also with the competent authority is essential and is therefore a sensible course of action.

Before the responsible entity determines that it is in the best interest of unit-holders to suspend redemptions, the responsible entity should ensure that any alternative course of action has been considered and discounted. The responsible entity should ensure that any suspension is temporary and consistent with the disclosure and other provisions set out in the CIS constitutive documents and/or prospectus.

In case of an unforeseen increase in illiquid assets, the responsible entity should take into account where possible, the investor profile. For example, if the CIS was exclusively sold to institutional investors, the responsible entity may be able to seek information from those investors and manage the situation with a view to avoiding the need to suspend (even for example by accepting in specie redemptions if permitted and where the NAV of the assets is not in question).

Other considerations that should be taken into account are for example expected redemption requests and the responsible entity's view of the market, in particular whether illiquidity is

likely to be short term and whether the pressure to sell assets would be likely to result in *fire sale* prices and a vicious circle scenario as mentioned in Chapter 2.

Principle 6
The decision by the responsible entity to suspend redemptions, in particular the reasons for the suspension and the planned actions should be appropriately:

a) documented;
b) communicated to competent authorities and other relevant parties;
c) communicated to unit-holders.

a) Documentation

The responsible entity should document the decision to suspend redemptions in a timely manner. Such documents should, where appropriate, describe in detail the reasons for the decision and explain the actions planned (with a view to the resumption of normal operations or to liquidation of the CIS).

Where appropriate, the responsible entity should also define objective criteria, the meeting of which will trigger the resumption of normal operations or the liquidation of the CIS. Such objective criteria can assist in what might otherwise be viewed as a purely subjective decision. The responsible entity should also consider how long a suspension should continue before it takes other actions in the best interest of the investors. National regulation may require additional documentation.

b) Communication to the competent authority and other relevant parties

The decision to suspend should be communicated to the competent authority.

The competent authority should be provided with all relevant information. The information to the competent authority should in particular include the documents referred to in Principle 6 a), i.e. the reasons for the suspension as well as any information the competent authority requires. The information should be filed as soon as practical. Depending on national rules, some jurisdictions may require a prior authorisation of the suspension or information before the suspension becomes effective. As described in the principle above, in any case an early engagement with the competent authority is necessary.

Moreover, competent authorities of those jurisdictions where the CIS is authorized to be marketed publicly should also be informed.

In any case, if the information filed with the competent authority indicates that the suspension is a result of poor management rather than external unpredictable factors (see Principle 4), the competent authority could take measures and consider exercising powers according to the national law, such as imposing sanctions or penalties against the persons responsible for the infringement of rules.

Other relevant parties, e.g. intermediaries and distributors should also be informed as soon as practical. In particular, the immediate cessation of active distribution of the CIS should be ensured (please refer to principle 7 hereunder).

c) Communication to unit-holders

Unit-holders should be appropriately informed about the decision to suspend redemptions. The equal treatment of unit-holders requires the information to be communicated in an appropriate and timely manner to all unit-holders and not only to the redeeming ones. The communication strategy of the responsible entity is crucial to avoid a heavy loss of confidence and reputation and therefore also spillover effects in the market, as discussed above. The information communicated to unit-holders and other interested persons should therefore be clear and comprehensive.

E. During the suspension

Principle 7
During the suspension of the redemptions, the responsible entity should not accept new subscriptions.

A suspension of redemptions should also imply a suspension of subscriptions. One exceptional situation, if permitted by national law, may be where the calculation to the unit price based on NAV could be achieved through objective and reliable means during a suspension.

However, in cases where subscriptions are allowed during the period of the suspension of redemptions by national law as a reliable NAV calculation can be ensured, any prospective subscriber should be informed about the suspension in a clear and comprehensive manner prior to the subscription, and given a chance to cancel the subscription order, before the order is accepted.

Principle 8
The suspension should be regularly reviewed by the responsible entity. The responsible entity should take all necessary steps in order to resume normal operations as soon as possible having regard to the best interest of unit-holders.

The responsible entity should review the decision to suspend redemptions on an ongoing basis during the period of suspension.

The responsible entity should monitor the market and the liquidity of respective instruments/assets held by the CIS on an ongoing basis. Within the regular review of the suspension the responsible entity should also take into account the expected redemptions. In the case of institutional investors or known large retail investors, the responsible entity should stay in close contact to obtain information from investors without prejudice to the principle of equal treatment of unit-holders. The expectation of redemption requests is necessary to know the level of liquidity that it will need to generate in order to meet the redemption requests after the lifting of the suspension to avoid rapidly suspending again.

The responsible entity should consider the length the suspension is in place and how long it may continue. The acceptable length of the suspension depends on the circumstances and the particular reasons for the suspension and on the applicable national law in some jurisdictions. The acceptable length may also depend on the way the CIS was marketed to investors. For example, if the CIS was marketed as highly liquid, the maximum suspension period generally

should be short. The responsible entity will need to consider alternatives sooner than otherwise.

Because the CIS in question are open-ended funds that offer redemption on a continuous basis, it is unacceptable that suspensions of redemptions remain in force for a long time. In this case the temporary problems affecting the CIS have become more structural and persistent. It could be argued that the longer a suspension lasts, when considering the interests of all unit-holders, increasing consideration should be given towards those who wish to access their money. The responsible entity should then consider alternatives, such as liquidation, or, if allowed, the changing of the CIS structure (e.g. to a closed end fund, or changes to the redemption policy) or the setting-up of side pockets (see following Chapter), unless the responsible entity and unit-holders of the CIS in accordance with applicable law agree to maintain the suspension so as to avoid liquidation.

However, those provisions may not be fully applicable in cases where competent authorities have authorized the suspension only for a limited period of time (e.g., only for the time the stock market is closed in response to an exceptional event).

Principle 9
The responsible entity should keep the competent authority and unit-holders informed throughout the period of suspension. The decision to resume normal operations should also be communicated as soon as practical.

a) Unit-holders

The communication strategy of the responsible entity should not end with the disclosure of the decision to suspend.

The responsible entity should ensure that unit-holders are kept updated throughout the suspension. The responsible entity should also deal with queries/questions from unit-holders and other interested parties. Moreover, any person who requests redemption or subscription of units should be informed that all dealings in units have been suspended. The resumption of dealings should immediately be communicated to unit-holders.

b) Competent Authority and other relevant parties

Where changes to the information originally submitted to the competent authority occur, the responsible entity should immediately inform the competent authority. Throughout the suspension the responsible entity should stay in close contact with the competent authority. The competent authority should also be informed of the proposed date for the resumption of normal operations.

Other relevant parties (e.g. intermediaries, distributors and depositories) should also be kept updated during the suspension.

F. Examples of alternative measures to deal with illiquidity in certain jurisdictions

Some jurisdictions also allow alternative tools to the suspension of redemptions to deal with extraordinary circumstances. For example, the activation of gating mechanisms or the creation of side pockets for specific open-ended CIS may be seen as an alternative to a

suspension or a full suspension, respectively. Moreover, the creation of a side pocket may be an alternative to the liquidation of the complete CIS.

a) Gating Mechanism

Gates allow the responsible entity to manage redemption requests in open-ended CIS. By using a gate, the responsible entity constrains the redemption amounts to a specific proportion on any one redemption day. For example, if the amount of redemption orders from one or more unit-holders exceeds the specific limit in relation to the CIS net assets, the redemption orders will only be partially executed. All redemption orders on the particular day will be proportionately reduced (due to equal treatment no *first come first served* principle) and the percentage of orders above the limit will either be denied or postponed and executed on the next redemption date. Gates could therefore deal with excess redemption requests that could arise in crisis periods. However, gates may only address extreme amounts of redemptions but not redemptions in general. They may be therefore less effective in the case of persisting large scale redemption requests. In any event, it is up to the responsible entity to assess whether the conditions required under national law are met and to decide, on the basis of its assessment, whether to activate gates.

Gates could be considered a restriction of unit-holders' rights to have their units redeemed. Hence, regulatory regimes of jurisdictions allowing for gates should provide for safeguards in relation to the activation of gates. In particular, for the purpose of protection and equal treatment of unit-holders, the constitutive documents and/or the CIS prospectus should specify that gates are applicable for the CIS and provide for a description of the gate mechanism (e.g. the predetermined thresholds for activating the gates). Depending on the jurisdiction authorizing them, gates may either cover extreme cases, or to the contrary, cover common redemptions. In the latter case, some jurisdictions may allow specific types of CIS a certain amount of flexibility in making use of those mechanisms as part of the regular liquidity management. In any case, gate mechanisms shall be set up with a view to a high degree of transparency and ensuring at all times the fair and equal treatment of investors.

b) Side Pockets

Some jurisdictions may allow the creation of side pockets for the illiquid assets held in a CIS portfolio, as a way to deal with more persistent episodes of illiquidity or valuation problems for a specific amount of assets in the CIS.

A side pocket is created when specific assets in the CIS portfolio are segregated and ring-fenced from the rest of the CIS portfolio. Jurisdictions may set a specific limit in relation to the NAV which is allowed to be assigned to the side pocket (maximum size of a side pocket).

1. In some jurisdictions, the creation of a side pocket requires that:

   (i) either a new CIS be created in addition to the original CIS:
   - in some jurisdictions, the new CIS will hold the liquid assets whereas the existing CIS will hold the illiquid ones;
   - in some other jurisdictions, the new CIS will hold the illiquid assets whereas the existing CIS will hold the liquid ones.

(ii) or depending on the jurisdiction concerned, that two new funds (one holding the liquid assets and one being the side pocket) be created in lieu of the original CIS.

Hence, in these jurisdictions, the setting up of a side pocket implies the co-existence of two separate funds (either the original CIS and the new one, or depending on the jurisdiction, two new funds) so that a clear segregation is ensured between the liquid and the illiquid assets of the original CIS. In fact, the two funds are:

- the side pocket (being either the original or the new CIS depending on the jurisdiction) comprises the illiquid assets whose liquidation or sale would not be in the best interest of the investors at the time of the side-pocket creation (for instance, if they are particularly distressed due to exceptional market turmoil). This side pocket is not due to be actively managed so that its management objective consists in liquidating the assets held by seeking the best timing and market opportunities in the best interest of investors (hence, the assets in the side-pocket cannot be transferred to the other CIS holding the liquid assets);

- and the other CIS consisting of the assets for which there are no liquidity problems.

2. Other jurisdictions treat side pockets as pools of assets that are only virtually segregated from the rest of the portfolio in the accountings of the CIS but formally the original CIS remains and includes the liquid assets as well as the assets in the side pocket.

However, in both cases the valuation of the segregated assets is done separately. In case of virtual segregation, the NAV of the CIS is based only on the liquid assets that have not been segregated i.e., not placed in a side pocket. New subscriptions are only possible for the liquid part (or the new liquid CIS, respectively) and based on the NAV calculated on the basis of the liquid assets, which does not include the assets segregated in the side pocket. Also, in both cases the unit-holder benefits from the proceeding of redemptions for the liquid CIS portfolio.

Only the proportion of assets assigned to the side pocket cannot be redeemed. Nevertheless, the unit-holder still participates in the side pocket performance and receives the proceeds of the liquidation of the side pocket's instruments/assets. In the case of the creation of a new closed end fund, unit-holders of the original CIS are provided with units of the new side pocket fund and of the new liquid fund in the same proportion as their investment in the original CIS.

As indicated earlier, the side pocket is in general not subject to full management activities as the purpose of its management is to liquidate the assets held in the best interest of unit-holders.

The reasons and circumstances for the creation of side pockets may differ from those of the suspension. The creation of a side pocket might be reasonable if factors that prevent the sale of assets are likely to persist over time and are not temporary. In such cases it might be advantageous to investors for the responsible entity to segregate and effectively suspend only the illiquid part, rather than to suspend the redemptions of the whole CIS.

However, regulators should treat the creation of side pockets carefully, since this possibility embeds a moral hazard problem. The creation of a side pocket might not give rise to the

same reputational risk as in the case of a full suspension. Therefore, a responsible entity may hide poor liquidity management and could also have a greater incentive to invest in illiquid assets to gain additional yield due to higher liquidity premia. Moreover, a responsible entity may hide poor management via side pockets to improve the performance of the remaining CIS (even if the CIS will incur a loss corresponding to the value of the assets included in the side pocket).

A regulatory framework that allows the creation of side pockets should therefore be appropriate to address these moral hazard problems. Equivalent principles to those set out above for the suspension could apply to the creation of side pockets. In particular, the possibility of setting up a side pocket should have been known ex-ante by the unit-holders through the constitutive documents and/or prospectus. The decision to set up a side pocket should always be communicated to the competent authorities according to the national rules. The responsible entity should be required to set out in writing the decision to set up a side pocket explaining the reasons for their actions. In this respect, a responsible entity should keep adequate records of all relevant documents. The responsible entity should immediately inform unit-holders about the functioning of the side pocket that has been set up, the reasons for its creation and planned future actions. The responsible entity should liquidate the assets of the side pocket as soon as possible in the best interest of unit-holders. Moreover, the regulatory framework may provide for a maximum amount of assets that could be segregated to the side pocket.

c) Discount

A few jurisdictions allow the application of a discount on the redemption price determined on the basis of the NAV, for redemption purposes in case of stressed markets or unusual and significant number of redemptions. The regulatory framework that allows such mechanisms should appropriately address related transparency and discretion issues. In particular, such a discount should only be applied if the reasons for its application were properly disclosed ex-ante in the prospectus. The discount should be applied consistently to all redemptions completed on the same day, and the amount of the discount shall benefit those unit-holders that did not redeem their units. The responsible entity should communicate the reasons and the mechanisms used to calculate the discount to unit-holders and the competent authority.