Suspending Redemptions:
A Case-Study from 11 September 2001
and
General Principles

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Regulation safeguards redemption on demand

Regulation of collective investment schemes (CIS) generally safeguards the fundamental features of CIS and provides, absent exceptional circumstances, that:

1. An investor in a CIS can redeem his or her interest in the CIS on demand and receive payment for that interest within a short period of time;

2. The purchase and redemption prices of an interest in a CIS are derived from the current market value of the CIS' assets less its liabilities; and

3. All investors in a CIS are treated fairly to the greatest extent possible.

Regulation also recognizes exceptional circumstances

Most regulatory regimes recognize that investors' rights to continuously purchase and redeem CIS interests may be affected when extraordinary events happen. Extraordinary events such as the closing of a financial market may mean that CIS assets cannot be accurately and fairly valued. Extraordinary events may also mean that CIS assets cannot be readily sold which in turn may mean that redemption requests cannot be easily or promptly met.[1]

A case-study from September 11, 2001

The Technical Committee through its Standing Committee on Investment Management (TCSC-5) has reviewed the principles regulators use to reinforce the fundamental features of a CIS while also recognizing the potential for extraordinary events that may mean these fundamental rights cannot be met.

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[1] CIS regulators may also consider an extreme situation when substantial numbers of investors seek to redeem their interests approximately at the same time to be an exceptional circumstance that may justify a redemption suspension. Large numbers of redemption requests, particularly at a time when few investors are subscribing for new units, may lead to liquidity problems for a mutual fund. The CIS may not have enough cash on hand and may not be able to dispose of assets at prices that reflect their market value sufficiently quickly enough to meet redemption requests. CIS regulation in Portugal reflects the possibility of mass redemptions occurring. CIS in Portugal may suspend redemptions if in a single day, redemptions (net of purchases) represent more than 5 percent of the CIS total assets or in five consecutive days, redemptions (net of subscriptions) represent more than 10 percent of the CIS total assets. CIS that suspend redemptions in these circumstances must notify the regulator immediately and are not required to suspend purchases. CIS in Portugal have not widely used this suspension ability.

The Technical Committee first reviewed responses to extraordinary events in 1999.[2] In 1999, the Malaysian government imposed currency controls which caused regulators in some countries to allow those CIS with substantial holdings in Malaysian securities or property located in Malaysia to suspend redemptions. Some regulators considered various mechanisms, such as allowing partial or provisional redemptions or ring fencing affected assets in order to allow investors to continue to redeem their CIS interests.

The Technical Committee has also considered the various regulatory responses taken in the aftermath of the September 11, 2001 terrorist attacks in the United States.

As a result of the terrorist attacks, the financial markets in the United States did not open or closed early on Tuesday, September 11, 2001. These markets, including the New York Stock Exchange, did not fully reopen until Monday, September 17, 2001. Air traffic was halted or disrupted during this period and many financial service providers suffered physical damage from the terrorist attacks, including physical harm to their agents, investment personnel, records and communications networks. Most United States mutual funds were closed and did not accept purchases and redemption requests from Tuesday, September 11 until Monday, September 17.[3]

The financial markets in Canada opened but closed early on September 11, and in Mexico did not open at all. Canada's financial markets reopened on Thursday, September 13 and the Mexican markets remained closed for the same period as the United States. Purchases and redemptions of all Canadian and Mexican mutual funds were suspended for the period that their applicable markets were closed.[4]

The U.S. Securities and Exchange Commission issued an emergency order that provided U.S. mutual funds with temporary exemptions from certain provisions of the U.S. Investment Company Act of 1940, but did not operate to extend their ability to suspend redemptions.[5] The emergency order was aimed primarily at eliminating certain legal barriers that might preclude funds from satisfying shareholder redemption requests, particularly in the event that funds could not borrow sufficient amounts of cash from banks. The exemptions also allowed CIS to deal practically with physical disruptions caused by the attacks by waiving the in person meeting requirements for fund directors. The details of the emergency order are summarized in Appendix A to this paper.

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[2] In preparing for Y2K, CIS and regulators also considered contingencies that redemption suspensions might be necessary in the period following January 1, 2000.

[3] The U.S. Investment Company Act of 1940 permits—but does not require—mutual funds to suspend redemptions on days that the New York Stock Exchange is closed.

[4] CIS regulation in Canada allows a CIS to suspend redemptions for any period during which trading is suspended on a stock exchange if the CIS holds securities listed on that exchange and those securities make up more than 50 percent of its total assets (and are not listed elsewhere). Mexican CIS cannot invest in non Mexican securities, hence, when its markets were closed, Mexican CIS suspended redemptions.

[5] The SEC has the power to determine that an emergency exists as a result of which it is not practicable for a CIS to liquidate its portfolio securities or fairly determine its net asset value. In the case of a SEC approved emergency, a CIS can suspend redemptions. The SEC did not use this power in the aftermath of September 11.

Other than in the U.S., Canada and Mexico, CIS in other countries did not generally suspend redemptions and purchases, unless they had a material exposure[6] to U.S. securities. Although many regulators have the power to require that redemptions and purchases be suspended, most regulators left this decision-making to the operators of CIS. In some countries, the decision to suspend redemptions was subject to regulatory approval.[7] Many regulators worked with their jurisdiction's industry trade association to ensure consistent treatment of CIS with U.S. exposure and worked to clarify that CIS without material U.S. exposure should remain open. Regulators generally reviewed industry guidelines or recommendations on when suspensions would be considered appropriate. In most cases, CIS that suspended redemptions also suspended purchases and remained closed only for so long as the U.S. market remained closed. Many regulators worked with industry participants to ensure that investors received notice of the suspensions.[8]

General principles for suspending redemptions

Redemption on demand is an essential and fundamental element of investor protection and should not be suspended absent extraordinary circumstances. Given the importance of this right to investors and the nature of CIS investing, CIS regulators emphasize the extraordinary nature of any suspension of this right.

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 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.

CIS constitutional documents should clearly establish when redemptions and subscriptions may be suspended and investors should be told about the potential that their right to purchase and redeem may be terminated in certain defined circumstances. A CIS operator should make the decision whether or not to suspend redemptions in light of valuation or other problems, in accordance with the CIS constitutional documents and the operator's responsibilities to investors. In all cases, a CIS operator should strive for equality of treatment of all security holders in the CIS it manages.

[6] Exposures to U.S. markets considered material ranged from 5 percent (Canada, Spain and Italy), to 10 percent (UK, Switzerland, Portugal, Ireland, France, Germany, Luxembourg) to 15 percent (Australia, Jersey). Redemption suspensions in the Netherlands were permitted for listed funds with exposure to U.S. markets (with no specified percentage). The Hong Kong SFC allowed redemptions suspensions without specifying a percentage. The percentage that might be considered material depends on the facts of the particular case, so these percentages should not be seen as a precedent for future cases.

[7] For example, a CIS having less than 50 percent exposure to a closed market must obtain regulatory approval to suspend redemptions in Canada. A suspension order was granted for those mutual funds with more than 5 percent exposure to U.S. securities. The maximum time period during which redemptions will be suspended must be approved in Portugal.

[8] Through, for example, questions and answers, copies of press releases and suspension orders posted on regulators' websites.

The experience of CIS in September 2001 reinforces the general principles outlined above. In many jurisdictions after September 11, 2001, many money market and bond CIS reinstated redemption processes very quickly or never suspended them. Similarly, many equity based CIS with exposure to a closed market opened redemptions promptly after the relevant market reopened or if an alternative market (where equity securities held by the CIS were interlisted) was open for trading. It was seen as important from a business perspective, that a CIS restore redemptions as soon as possible once a reasonable market price for the underlying assets of the CIS could be determined. During this period, good business practice coincided with regulatory objectives.

Regulators also may provide CIS with additional flexibility to deal with redemption requests in an emergency situation, but where no fundamental valuation problem exists, so that redemption requests can be fairly managed. This additional flexibility is intended to permit CIS to continue to allow redemptions and purchases where an appropriate fair value can be obtained, while recognizing that emergencies may necessitate some controls on redemptions. Regulators can consider allowing:

- ♦ Limited additional borrowing by CIS so that redemption requests can be met and an orderly disposition of portfolio securities encouraged. This approach was taken by the SEC in its September emergency order.

- ♦ Partial redemptions and purchases based on prices derived from underlying portfolio securities that can be readily valued. Once a complete valuation can be determined, adjustments (by the CIS, in the case of redemptions, and by the investor, in the case of purchases) are made. Delayed payment of redemption proceeds could also be instituted. For example, CIS regulation in Spain recognizes a practice of partial redemptions and purchases. Appendix B outlines the regulatory scheme in Spain.

Whenever an emergency situation exists that materially affects valuation or liquidity of a CIS, regulators encourage CIS operators to communicate with investors about the reasons for any suspension or other action and its likely timeframe. Communication is important to preserve investor confidence.

Appendix A

Emergency Order of the U.S. Securities and Exchange Commission

September 14, 2001

The U.S. Securities and Exchange Commission's emergency order provided funds and their affiliated persons with the following exemptions from the Investment Company Act of 1940 (the Act):

- **Borrowing contrary to disclosure in registration statements, without shareholder approval**—The Commission's emergency order effectively permitted funds to engage in borrowing contrary to their disclosed policies for 5 business days, provided that: (1) the board of directors of the fund, including a majority of the directors who were not interested persons, reasonably determined in the exercise of its judgment that such borrowing was in the best interests of the fund and its shareholders; and (2) the fund promptly notified shareholders of the borrowing.

- **Borrowing from entities other than banks**—The Commission's emergency order permitted funds to borrow money from entities other than banks for 5 business days, provided that the board of directors of the fund, including a majority of the directors who were not interested persons, reasonably determined in the exercise of its judgment that such borrowing was in the best interests of the fund and its shareholders.

- **Affiliated lending**—The Commission's emergency order permitted any affiliated person of a fund (other than another fund) to make secured loans to the fund for 5 business days, provided that the fund's board of directors, including a majority of the directors who were not interested persons of the fund, reasonably determined in the exercise of its judgment that the fund's borrowing from the affiliated person was in the best interests of the fund and its shareholders.

- **Interfund lending**—The Commission's emergency order allowed certain affiliated funds that had previously received orders from the Commission permitting them to borrow and lend money among themselves to do so to a greater extent (i.e. in an aggregate amount that did not exceed 25 percent of the fund's current net assets at the time of the loan).

- **In-person director voting requirement**—The Commission's emergency order exempted funds for 30 calendar days from the Act's requirements that certain matters (e.g. advisory contracts, independent accountants and distribution plans) must be voted on by fund directors at in-person meetings, subject to the following conditions: (1) the votes required to be cast at an in-person meeting must be cast at a meeting in which the directors can participate by any means that allows the directors to simultaneously communicate with each other during the meeting; (2) the action does not result in any material change to the existing contract, plan or arrangement under

> consideration; and (3) the board of directors, including the majority of directors that are not interested persons of the fund, ratifies the action taken pursuant to the exemption by a vote cast at an in-person meeting within 90 days of the date of the action that is taken.

The Commission's emergency order was very narrowly tailored to address only these matters, and did not affect other fundamental prohibitions of the Act. For example, the order did not authorize funds to borrow more than 50 percent of their total assets (before the borrowing) from banks, and it did not authorize funds to otherwise engage in transactions with affiliated persons. The order also did not permit funds to suspend redemptions. It was unnecessary for the emergency order to authorize funds to suspend redemptions while the New York Stock Exchange was closed, because the Act permits funds to suspend redemptions during this time. The Commission chose not to suspend redemptions after the NYSE reopened, rather it provided the relief in the emergency order to assist funds in satisfying shareholder redemption requests.

Appendix B

Regulatory Scheme for Redemptions in Spain

The Spanish regulatory regime for CIS aims to provide a system for valuation of CIS assets, pricing of interests and procedures for purchases and redemptions that are fair to existing investors, as well as to investors seeking to purchase or redeem interests. As a general rule, a CIS must redeem its units at the request of any investor, in a manner and frequency laid down in the CIS prospectus and rules of incorporation. Purchase and redemption orders must be executed at the same net asset value price determined in accordance with accepted accounting principles used on a consistent basis. The price of interests in a CIS must be calculated according to their market price.

If less than 5 percent of the assets of a CIS are affected by a market suspension, purchase and redemption orders must be satisfied at a price calculated according to general accounting rules.

In any other case of market suspension, Spanish CIS legislation provides for a mechanism of partial purchases and redemptions. Prices for these partial purchases and redemptions are based on the market value of the underlying assets of the CIS that are not subject to a market suspension. Orders are completed once a reasonable market price for the underlying assets can be ascertained.

The Spanish system of partial purchases and redemptions permits an investor to exercise his or her rights to liquidate investments or to make investments, both on a partial basis. Final determination of the amount to be paid by the investor (on a subscription) and by the CIS (in the case of a redemption) is delayed until a fair price for the interest can be determined. Investors, in the case of a partial purchase, and CIS operators, in the case of a partial redemption, must pay the balance of the purchase or redemption price once the fair market value is restored. Orders for partial purchases or redemptions must clearly describe the obligation on investors or CIS operators to make the final payment when it is due.

Spanish CIS legislation also provides that the Spanish regulator can suspend purchases and redemptions, including on request of a CIS operator, when it is not possible to determine a market price or in case of force majeure.