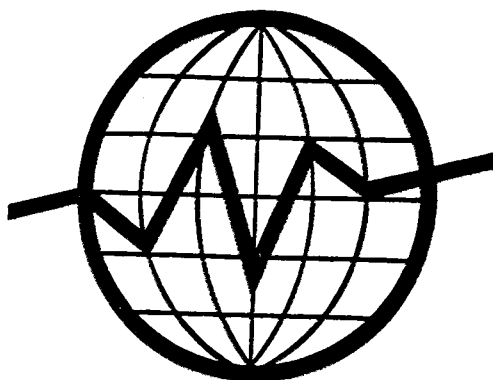


REGULATORY COOPERATION IN EMERGENCIES

A DISCUSSION PAPER



**Technical Committee
of the
International Organization of Securities Commissions**

June 1996

This discussion paper was prepared by the Technical Committee Working Group on Investment Management ("Working Group No. 5"). It was approved by the Technical Committee during its June 4, 1996 Edinburgh meeting.

BACKGROUND

1. Following the Windsor Declaration of May 1995, IOSCO Working Party Number 5 on Investment Management now seeks to address the issues of regulatory cooperation in emergencies involving collective investment schemes (CIS). These issues may arise in any instance involving cross-border activity of a CIS, any of its principal parties (investment manager, operator or custodian) or their affiliated entities. Such issues may arise in a number of ways; the purpose of this paper is to identify the main scenarios involving CIS emergencies and consider the regulatory cooperation policies to be applied to these and, in particular, the policies that may be applied in determining suspension of redemption of CIS units.

CRISIS SCENARIOS

2. The insolvency or threatened insolvency of the CIS manager, trustee, custodian or the affiliated companies of any of these entities, as happened with Baring, is perhaps the most common scenario to trigger a crisis. Although under this scenario the CIS assets themselves would be expected to remain unaffected (except for the cash portion that is the subject of a separate paper), insolvency of a principal party is likely to give rise to both domestic and overseas regulatory concerns and at least temporary suspension of dealing in CIS units. Other scenarios would include administration-related events within the CIS or the insolvency of the CIS itself.
3. Although structural arrangements and regulatory oversight are designed to prevent such occurrences, a crisis scenario involving misappropriation of funds also remains possible. Consequences of such action would depend on the nature of the malpractice but are likely to include administrative and/or criminal action taken against the individuals or entities involved. Depending on its powers in such matters the regulator may seek to replace the entities concerned with other parties and to carry out an independent enquiry. Consequences for investors are also likely to depend on the nature of the malpractice and availability of remedies, such as compensation schemes, under the law of the CIS domicile.
4. The issues likely to be faced by regulators in a crisis include the following:

Domestic Regulatory Concerns

5. In the case of insolvency, where jurisdictions in which the entity carries on business have financial resources requirements, the entity's fitness to remain registered or licensed to operate will be under review. Withdrawal of regulatory approval will affect the entity's ability to carry out its contractual and statutory functions vis-à-vis the CIS. Such matters may not be taken into account by one regulator if the CIS is located in another jurisdiction.

Market Concerns

6. Notwithstanding the domestic regulatory position, other players in the market may consider themselves to be at risk by continuing to trade with an insolvent entity, even if that entity is acting on behalf of a solvent CIS. This can result in the effective withdrawal of the facilities of the market and consequent inability of the entity to carry out its obligations vis-à-vis the CIS. This was an important and unanticipated problem during the Baring crisis, when market perceptions of counterparty risk effectively prevented Baring as fund manager from managing CIS assets held in segregated custody accounts.

Cash Flow Problems

7. If the insolvent entity acts as custodian to a CIS, fund flows such as settlement of transactions and processing of customer orders will be affected. The other notable effect of custodian insolvency is on cash deposits: if the custodian bank is placed in administration, deposits will be frozen; if the bank is in liquidation the fund may, subject to the protection of any compensation scheme, be treated as any other unsecured creditor.

Suspension of Dealing

8. All or any of the above could (and in most cases, would) result in a manager's, trustee / depository's or regulatory authority's decision to suspend dealing in a CIS. In addition, insolvency of a principal party could trigger investor panic and a rush of redemption requests, which could likewise lead to a suspension of dealing.

POLICIES FOR COOPERATION

9. With increased internationalisation of the markets in which CIS and their principals operate, the above scenarios can have significant cross-border implications. Any of the principal parties to a CIS or an affiliated entity may operate in a number of jurisdictions world-wide. Regulatory action in one jurisdiction may affect the entity in other jurisdictions, either directly or by way of market perception. If the CIS itself is authorised elsewhere, regulatory action by the home regulator may affect the CIS's activities in different ways in each of those jurisdictions.
10. It is therefore likely that emergency decisions taken by regulators regarding CIS players will in some way affect other regulators. Given this interaction, it is suggested that awareness, communication and in appropriate circumstances, consultation should characterise this relationship, as discussed below.

Awareness

11. Regulators should, as far as possible, be aware of the cross-border activity of the entities (CIS and / or principal parties) which they regulate. This could be, for example, the result of a requirement on the CIS to advise the regulator of its cross-border activity. Names and contact details of the principal overseas regulators who may have an interest in the entity should be maintained on a regular basis,

and appropriate procedural arrangements should be in place to permit exchange of confidential information when necessary. In the case of insolvency, for example, a regulator should promptly obtain, if it does not already have, information on the domiciles, and relevant regulatory authorities, of that entity's affiliates as well as on the functions carried out by this entity for domestic or foreign CIS.

Communication

12. Subject to the necessary confidentiality arrangements (see paragraph 11), during emergencies, communication of any decisions or state of affairs known about the entity should be made as promptly as possible to the principal overseas regulators. After-hours telephone numbers should be available for this purpose.
13. Communication to market participants may also be an important element in containing a crisis. For example, in the case of insolvency, where market concerns threaten to exacerbate a crisis, clear communication by the regulator can help to mitigate the damage. During the Baring crisis, positive action by regulators to confirm to market participants that the various Baring entities acting on behalf of the funds continued to be licensed was able to contain some of the damage caused by market concerns.

Consultation

14. Although regulators will invariably be bound by local laws imposing local obligations, where a decision is likely to have a material impact on the entity's activities in another jurisdiction, it would be desirable for the home regulator to take into account the effect of the decision outside the home jurisdiction. If possible, and if such a course of action does not conflict with the regulator's own responsibilities, the deciding regulator should consult the foreign regulator prior to making the decision.
15. For example, if a fund management entity licensed in Country X manages funds domiciled in Country Y, Regulator X should consider, to the extent it is aware of it, the effect on Regulator Y of any decision to restrict the management activities of the entity. Where, however, the CIS is domiciled in one jurisdiction, with the majority of investors domiciled in another, the regulator of the jurisdiction of domicile should consult the regulator in the jurisdiction where the investors are located.

PRINCIPLES FOR SUSPENSION OF DEALING

General Policy

16. IOSCO's Principles for the Regulation of Collective Investment Schemes clearly recognise that systematic and regular valuations (or "pricing") of CIS assets and the routine redemption of CIS units are fundamental functions of any open-ended CIS. The Principles also recognise that there are circumstances when routine pricing and redemption may have to be suspended for the protection of investors, as set out in Principle 7.2.2:

" Redemption of units may only be suspended on a temporary basis. Any such suspension must be in accordance with the procedures provided for by law or the CIS rules and must be in the interests of investors. A CIS must inform the regulatory authority of a suspension. In accordance with the laws of its jurisdiction, a regulatory authority may permit a CIS to suspend the right of redemption for the protection of investors."

Regulatory Authority and Procedures

17. Because it may be necessary for regulatory authorities to act quickly in emergencies, their authority to act and the procedures for doing so should be well established. In some jurisdictions the responsibility for suspension will be that of the trustee, custodian or CIS operator but regulatory authorities may have the power to act on their own to suspend pricing and redemption obligations. Where this power exists, its authority should be expressly set out in the relevant law or regulations to avoid the uncertainty that could delay a regulator's response in an emergency.
18. All of the specific circumstances that may give rise to suspension are generally not spelt out in the applicable law or regulations, the decision often being left to the fiduciary obligations of the party concerned, or in the case of the supervisory authority, the public or investors' interest. For example, U.S. law sets out some general circumstances such as the closing of the New York Stock Exchange.
19. As a matter of principle, however, because routine pricing and regular redemption are fundamental obligations of open-ended CIS, they should be suspended only when they are impossible or extremely impracticable to carry out. Accordingly, a regulatory authority should not permit suspension of dealing unless it was satisfied, based on all the circumstances, that there is no other available method or avenue for pricing and redemption that would be fair to CIS investors.

Circumstances Requiring Suspension of Dealing

20. A CIS may need to suspend its pricing and redemption obligations as a result of any number of unexpected events or emergency situations that affect the ability of the CIS to properly value its assets or process redemption requests. Generally such events can be grouped into three broad categories:

Emergencies and Disasters

21. This category includes emergency situations and events affecting the operation of securities markets and CIS service providers. Examples include national political emergencies or natural disasters that close down essential services, businesses and markets.

Market-Related Events

22. This category includes disruptions of (or periods of extreme volatility in) the securities markets that would make it impossible for a CIS to accurately value its portfolio securities. One example would be the unexpected closing of the primary exchange on which a significant portion of the portfolio securities of the CIS is traded.

CIS-Specific Events

23. This category includes events particular to a CIS that make pricing and redemption impossible or extremely impracticable. CIS-specific events could be caused for example by the failure, insolvency or incapacity of the CIS manager or other principal party, the fraud or negligence of any of these parties, or any other event established by the CIS rules.

Criteria for Determining Suspension of Dealing

24. The basic principles behind suspension policy can be summarised as follows:
- * that dealing should be suspended if the underlying CIS assets cannot be fairly valued;
 - * in the case of massive redemption requests, (subject to no other options being available) to permit an orderly liquidation of the necessary percentage of the portfolio; and
 - * to ensure a balance of interests between exiting and remaining investors, or, in the case of failure of administration of the CIS, where the individual holdings of investors cannot be properly identified.
25. The following questions are therefore proposed as a guide to fulfilment of these obligations.

Can the CIS Assets be Valued?

26. This is clearly not possible if a market for a material portion of CIS assets is closed, where the means of valuation breaks down, or during any emergency affecting either the CIS assets or operations. In addition, fair valuation may also be impracticable in extreme market conditions, for example when there is an unusually wide spread between bid and offer prices.

Is the CIS Sufficiently Liquid to Meet Redemption Requests?

27. Even if it is possible to value the CIS during a crisis, suspension may be necessary if there are massive redemption requests. In certain jurisdictions this trigger is 10%, and generally corresponds to the maximum permitted borrowing to meet such requests. However, provided that the underlying assets are still fundamentally liquid, suspension in this case should only be necessary for as long as it takes the CIS to liquidate the required portion of its assets.
28. To decrease the possibility of a suspension of dealing due to massive redemption requests, a CIS could, to the extent permitted by the regulations, maintain as liquid a portfolio as possible and to put in place alternative liquidity facilities. Most regulatory authorities already place a limit on the percentage of CIS assets that may be invested in illiquid securities. To the extent permitted by their regulations, CIS should also implement lines of credit or other borrowing facilities to provide liquidity to meet redemptions without the need for immediate liquidation of portfolio assets. Some jurisdictions permit dealing to be deferred when redemptions reach a certain level, usually 10% of net asset value, to permit the manager to liquidate the necessary portion of the portfolio to meet redemption requests. Other jurisdictions permit redemptions to be paid in kind to meet large redemption requests.

Is Suspension in the Interests of Investors?

29. If the assets can be valued and redemptions have not reached the suspension “trigger” under the law of the CIS domicile, “interests of investors” should generally mean that the right to redeem should not be suspended provided those interests can be clearly identified.
30. A large number of CIS are now domiciled in “offshore” jurisdictions where the vast majority, if not all, of the investors are domiciled elsewhere. In such case the home regulator should take into account the interests of all investors, including the foreign investors, and the views of the foreign regulators in determining such interests.
31. Given the fundamental nature of the redemption obligation, regulatory authorities should tailor any relief given with respect to suspensions to the extent necessary to fit the particular emergency, and ensure that any suspension is as brief as possible.