MANAGED FUNDS ASSOCIATION
The Voice of the Global Alternative Investment Industry
WASHINGTON, DC | NEW YORK

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Via Email: cisliquidity@iosco.org

Mohamed Ben Salem
International Organization of Securities Commissions (IOSCO)
Calle Oquendo 12
28006 Madrid
Spain

Re: Managed Funds Association Comments on Principles of Liquidity Risk Management for Collective Investment Schemes

Dear Sir,

Managed Funds Association ("MFA")[1] welcomes the opportunity to respond to the International Organization of Securities Commissions' ("IOSCO") Consultation Paper on Principles of Liquidity Risk Management for Collective Investment Schemes (the "Consultation Paper"). MFA seeks to work constructively with policy makers and regulators to help them achieve effective and efficient oversight. We generally believe that the principles set out in the Consultation Paper establish an effective framework for liquidity risk management of collective investment schemes ("investment funds"). We are concerned; however, that some of the discussion points and recommendations in the Consultation Paper contain suggestions that are not well suited for certain types of investment funds, such as hedge funds. Our comments in this letter focus on the application of the principles and accompanying recommendations to hedge funds, and not to other types of investment funds.

Background

In considering the application of the principles in the Consultation Paper to hedge funds, it is important to consider the structure of the hedge fund industry. The structure and business model of hedge funds distinguishes them from other types of investment funds. Hedge funds do

[1] The Managed Funds Association (MFA) represents the global alternative investment industry and its investors by advocating for sound industry practices and public policies that foster efficient, transparent, and fair capital markets. MFA, based in Washington, DC, is an advocacy, education, and communications organization established to enable hedge fund and managed futures firms in the alternative investment industry to participate in public policy discourse, share best practices and learn from peers, and communicate the industry's contributions to the global economy. MFA members help pension plans, university endowments, charitable organizations, qualified individuals and other institutional investors to diversify their investments, manage risk, and generate attractive returns. MFA has cultivated a global membership and actively engages with regulators and policy makers in Asia, Europe, North and South America, and all other regions where MFA members are market participants.

not accept retail investors; they are limited to sophisticated investors. They also do not provide instant liquidity like money market or other mutual funds.

Hedge funds build strong liquidity protections into their contractual relationships with investors. Hedge fund investors are subject to limited periods of redemption (sometimes monthly, but more often quarterly, annual, or longer), often with a notice requirement. Hedge fund managers also typically have the right to employ other techniques, such as "gates," "lock-ups," and "side-pockets" to help manage their liquidity and to prevent forced asset sales. Hedge funds typically structure their redemption and lock-up requirements to complement the levels of liquidity and leverage the fund expects to use. The UK Financial Services Authority noted in its February 2012 Hedge Fund Survey that, since its Hedge Funds Survey has been running (since 2005), the results demonstrate that hedge funds' portfolios can be liquidated more quickly than their liabilities fall due.[2]

Similar to the structuring of investor redemption rights, hedge funds structure their financing arrangements in light of their investment strategy and the liquidity of the assets they hold. Unlike many other financial market participants, hedge funds do not rely on unsecured, short term financing to support their investing activities. Instead, hedge funds rely on secured borrowings, which are designed to more closely match the term or expected liquidity of the asset and the financing which funds it. Indeed, banks do not provide uncollateralized loans to hedge funds. This practice is also true with respect to derivatives transactions. Hedge funds pay initial margin and exchange variation margin with their derivative counterparties, a market practice that is also a key component of derivatives regulation in the U.S. under Title VII of the Dodd-Frank Act and in the EU under the European Market Infrastructure Regulation.

Discussion of IOSCO Principles

Principle 4 -- Where permissible and appropriate for a particular CIS, and in the interests of investors, the responsible entity should include the ability to use specific tools or exceptional measures which could affect redemption rights in the CIS's constitutional documents

We agree that provisions such as liquidity risk management tools that can affect redemption rights should be disclosed to investors. We note that the discussion following principle 4 includes examples of liquidity risk management tools. There are other important liquidity management tools that are often used by hedge funds, including fund level gates and notice periods, which we encourage IOSCO to include in the list of examples.

The discussion also includes examples of so-called "exceptional measures." Side pockets are listed as an example of an exceptional measure. Hedge fund managers may use side pockets in the regular course of business for certain types of investments, such as investments in illiquid instruments. As such, we encourage IOSCO to amend the Consultation Paper to clarify that side pockets are not necessarily an exceptional measure. This clarification is important, given the recommendation in this section (as well as in the discussion following principle 15), which

[2] http://www.fsa.gov.uk/static/pubs/other/hedge-fund-report-feb2012.pdf

provides that investment funds should not be managed in a way that relies on these types of exceptional measures.

Principle 5 -- The responsible entity should consider liquidity aspects related to its proposed distribution channels

We agree with the principle that the responsible entity for an investment fund should consider the impact of likely investors (and their redemption rights) on the liquidity profile of the fund. The discussion following principle 5 goes further; however, recommending that responsible entities for investment funds should take all reasonable steps to obtain investor concentration information from nominees. It may be impractical for investment funds to get investor concentration information from nominee investors. Moreover, liquidity management tools, such as gates (fund level or investor level), are designed to address liquidity issues arising from potentially large redemption requests. We believe these types of tools are better suited to addressing potential liquidity issues that can arise with investors that have significant ownership of a fund.

Principle 7 -- The responsible entity should ensure that liquidity risk and its liquidity risk management process are effectively disclosed to prospective investors

We agree that material information about liquidity risk and liquidity risk management should be disclosed to investors. We are concerned; however, that the recommendation that day-to-day liquidity information should be made readily accessible would be overly burdensome for funds and their responsible entities without providing significant value to investors, particularly with respect to funds that have limited redemption rights. We also note that the text is unclear about the scope of information that should be provided. We encourage IOSCO to modify the text to recommend that investment funds and their responsible entities provide material liquidity information to investors, in light of the redemption rights of investors in the fund.

Principle 8 -- The responsible entity should effectively perform and maintain its liquidity risk management process

We agree that effective liquidity risk management is a dynamic process that requires ongoing monitoring and evaluation by a fund's manager. The discussion following principle 8 provides that the liquidity risk management process should be updated if the investment fund invests in a new type of asset or if the results of distribution of the fund results in a different investor profile than anticipated. It is unclear why an investment fund or its responsible entity would need to update its risk management processes because of a different investor profile, unless the change in profile also means a change in redemption rights. We encourage IOSCO to clarify that investment funds or their responsible entities should update their risk management processes to the extent that a change in the investor profile of the fund has a material impact on the redemption rights of investors in the aggregate.

Principle 9 -- The responsible entity's liquidity risk management process must be supported by strong and effective governance

We agree that an effective risk management process requires appropriate governance. The discussion following principle 9 recommends that the responsible entity for an investment fund have an appropriate degree of independent oversight involved in reviews of the liquidity risk management process. It is unclear what independent oversight means in the context of an internal liquidity risk management process. We encourage IOSCO to clarify that the appropriate degree of independent oversight will vary among responsible entities for investment funds based on differences in business models, including the governance structure and size of such entities.

Principle 10 -- The responsible entity should regularly assess the liquidity of the assets held in the portfolio

We agree that the party responsible for the liquidity risk management process should regularly monitor and assess the liquidity of the portfolio. The discussion following principle 10 provides that the liquidity risk management process should enable the responsible entity to continuously measure, monitor and manage the investment fund's liquidity. We are concerned that this recommendation would be difficult, if not impossible, to meet for many firms, particularly if continuous measurement is interpreted to require real-time measurement. We encourage IOSCO to modify this recommendation to provide that the appropriate timing and frequency of the review of the portfolio will vary from fund to fund based on a variety of factors, including the strategy, type of assets, and overall liquidity profile of a fund's portfolio.

Principle 11 -- The responsible entity should integrate liquidity management in investment decisions

Similarly, while we agree that liquidity risk management plays an important role in the investment activities of an investment fund, we are concerned that the recommendations following the principle would be unworkable for many funds. Specifically, we are concerned about the recommendation that the responsible entity should consider the liquidity of instruments it intends to purchase and the impact on the investment fund's liquidity before transacting. It is not practical for fund managers to consider the impact on overall liquidity on a trade-by-trade basis prior to executing every investment transaction. We encourage IOSCO to modify this recommendation to provide that an investment fund's liquidity risk management process contain provisions reasonably designed to ensure that investment decisions are consistent with the overall liquidity profile established for the fund.

Principle 12 -- The liquidity risk management process should facilitate the ability of the responsible entity to identify an emerging liquidity shortage before it occurs

While we agree that a dynamic liquidity risk management process should be, in part, forward-looking, the IOSCO principles should be careful not to overstate the ability to predict future events.

The discussion following principle 12 also provides that responsible entities should avoid using tools or exceptional measures that may affect redemption rights. Similar to the recommendations following principle 4, these recommendations should distinguish between the use of liquidity tools and extraordinary measures. Tools such as notice periods, limited periods for redemption, and gates, among others, are used by many investment funds and their responsible entities as part of the normal liquidity risk management process. We encourage IOSCO to modify this provision so as not to discourage the use of liquidity risk management tools.

Further, the discussion provides that responsible entities should make best efforts to ensure future cash flows are as predictable as possible. Managing expected cash flows is an important component of a liquidity risk management process; however, it may not be appropriate or desirable for responsible entities to make best efforts to ensure predictable future cash flows. This could unduly limit investment options or distribution opportunities for a fund. We encourage IOSCO to modify this recommendation to provide that the liquidity risk management process should be designed, in part, based on reasonable expectations of future cash flows.

Principle 13 -- The responsible entity should be able to incorporate relevant data and factors into its liquidity risk management process in order to create a robust and holistic view of the possible risks

We agree with the principle that investment funds and their responsible entities should develop a liquidity risk management process that creates a robust view of possible risks. We are concerned; however, with the recommendation that the responsible entity should consider quantitative and qualitative factors to ensure that in all but exceptional circumstances the investment fund can always meet its liabilities as they fall due. Investment funds and their responsible entities can develop reasonable policies, but they cannot ensure outcomes. Accordingly, we encourage IOSCO to modify this recommendation to provide that investment funds and their responsible entities should reasonably design processes intended to achieve the desired outcomes.

The discussion also provides that responsible entities should not provide preferential disclosure to select investors. Sophisticated investors often negotiate investment terms, including the type of reporting the investor will receive, through ‘side letter’ arrangements, which are permitted in many jurisdictions. To the extent permitted by law, investment funds should be permitted to negotiate terms with individual investors. We encourage IOSCO to modify this recommendation to make clear that such negotiated terms may be limited in certain jurisdictions and permitted in other jurisdictions and that investment funds and their responsible entities should only provide such disclosure to the extent permitted under applicable law.

The discussion further suggests that an investment fund’s responsible entity could identify investors with a large holding in the fund and keep up-to-date about whether the investor intends to make a large redemption. Most hedge funds engage in regular dialogue with their

investors; however, as discussed above, liquidity risk management tools (such as gates) are more appropriate for managing liquidity than trying to determine the intentions of investors.

We would be happy to discuss our comments or any of the issues raised in the Consultation Paper with IOSCO. If IOSCO has any comments or questions, please do not hesitate to contact Benjamin Allensworth or the undersigned at +1 (202) 730-2600.

Respectfully submitted,

/s/ Stuart J. Kaswell

Stuart J. Kaswell
Executive Vice President &
Managing Director, General Counsel