IOSCO Report on Good Practices for the Termination of Investment Funds

Final Report

The Board
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INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS

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Chapter 1 – Introduction and Scope

1.1. Purpose

This report sets out good practices on the voluntary termination process for collective investment schemes ('CIS') and other fund structures such as commodity, real estate and hedge funds (hereinafter collectively referred to as 'investment funds'). An investment fund for the purposes of this document shall include sub-funds thereof.

The termination of an investment fund is part of its natural life span. Investment funds terminate for many different reasons, including weak investor demand, unfavourable economic conditions or commercial decisions by the entity responsible for the overall operation of the investment fund ('responsible entity') [1] to restructure. In some cases, funds may also need to terminate if significant redemptions make them no longer viable.

The ability to terminate an investment fund and the circumstances when the termination may occur are typically prescribed in law or in the constitutional documents of an investment fund, or both. In practice, terminations may require the execution of a specific plan in coordination with key stakeholders, such as the investors, the board of the investment fund, the responsible entity, the depositary and/or custodian,[2] the regulator (and possibly a liquidator in some circumstances), followed by a range of other service providers (e.g. auditors, legal counsel, brokers, transfer agents, distributors, etc.).

The decision to terminate an investment fund can have a significant impact on investors in terms of the cost associated with such an action or the ability of investors to redeem their holdings during the termination process. Throughout this process investors, whether retail or professional,[3] have an important stake linked to the ultimate value of their investment in a fund at the time of termination and their ability to withdraw their investment from the fund in a timely manner.

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1 The 'responsible entity' shall be taken as meaning the entity/entities responsible for the overall operation of the investment fund and in particular its compliance with the legal/regulatory framework in the respective jurisdiction. The identification of the responsible entity may vary among jurisdictions and types of investment funds. In some jurisdictions, the responsible entity could be the management company, CIS operator or the investment fund itself. In others, the management company may play a role in carrying out the principles, but may be overseen by an independent body (e.g. board of directors).

2 The term depositary / custodian may be used interchangeably throughout and have the same meaning for the purposes of this paper. In jurisdictions where an investment fund is structured as a trust, the custody function may be undertaken by the trustee.

3 For the avoidance of doubt, the term 'professional investors' also includes institutional investors.

Most regulatory regimes have certain criteria for the termination of investment funds in their jurisdiction, ranging in detail from the overarching obligation to act in the best interests of investors to prescriptive requirements for liquidating the portfolio and the payment of final distribution proceeds. IOSCO recognises the importance for investment funds to have termination procedures in place from an investor protection perspective. For this reason, IOSCO's Committee on Investment Management (Committee 5) has developed a set of good practices for the termination of investment funds which take into account investors' interests during this process.

The decision to terminate is specific to the investment fund in question and takes into account a number of different factors and circumstances relevant to the investment fund at a particular point in time. IOSCO is mindful that not all of the good practices mentioned throughout will be applicable in all circumstances given the individual nature of investment fund terminations.

These good practices address voluntary terminations, as legislation at a national level in most jurisdictions addresses involuntary terminations (for example, in the case of insolvency of an investment fund). Voluntary terminations typically occur because an investment fund, although still solvent, is no longer economically viable or can no longer serve its intended objectives. The decision to terminate in these cases is taken by the responsible entity although this decision may be based on factors outside its direct control (for example, in cases where the fund service provider (e.g. the custodian or investment manager) has resigned but it is not possible to appoint a suitable replacement). The investment fund is typically terminated in accordance with the provisions in its constitutional document and/or prospectus in conjunction with the legal/regulatory processes in place for the orderly termination of investment funds in that jurisdiction.

The good practices do not override national or regional legal or regulatory requirements and/or insolvency regimes. The regulatory steps taken in different jurisdictions may include general principles, prohibited practices or precise rules in relation to conduct and disclosure requirements. The approach varies among jurisdictions depending on their regulatory framework, the structure of their national asset management landscape and the regulator's assessment of the risks and problems facing investors. Generally, they reflect approaches to issues currently acknowledged by regulators and therefore serve as useful guidance to the investment funds industry. Moreover, while relevant in some cases, the good practices prescribed in this document may not be applicable to involuntary terminations.

In a number of jurisdictions, an investment fund may elect not to terminate by liquidating its assets and repaying investors, and instead will seek to merge its assets with another investment fund often managed by the same responsible entity. In this regard, a section of

the report considers issues arising from investment fund mergers generally, as identified by IOSCO in 2004,[4] and how these impact on the termination process.

1.2. Scope

This report sets out proposed good practices for the voluntary terminations of open-ended and closed-ended investment funds. The scope is not limited to retail investment funds as it also addresses issues of relevance to investment funds for professional investors.

Illiquid or hard to value securities can have a direct impact on the voluntary termination of investment funds, particularly for funds established as commodity funds, real estate funds or hedge funds. This report sets out additional good practices specific to the termination of these types of investment funds.

1.3. Application of Existing IOSCO Principles

Various aspects of the IOSCO Objectives and Principles of Securities Regulation[5] have a bearing on the subject of investment fund terminations; however, Principle 25 is of most relevance.

Principle 25 states that "*the regulatory system should provide for rules governing the legal form and structure of CIS and the segregation and protection of client assets*". The methodology for assessing the level of implementation of Principle 25 specifically considers whether the regulatory system adequately provides for the orderly winding up of a CIS.

Noting that the legal form and structure of investment funds vary among jurisdictions, the methodology stresses the importance of protecting investors as the structure affects the interests and rights of the participants in the investment fund and enables the pool of investors' funds to be distinguished and segregated from the assets of other entities and of the responsible entity. The methodology further notes the importance of, *inter alia*, protecting the interests of investment fund investors not only while the investment fund is a going concern, but also when its continuity is affected by circumstances which require it to be terminated. To effectively implement this principle, the methodology provides that the regulatory system should require the rights of investors in investment funds, or impediments to investors exercising their rights, to be clearly spelled out.

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4 IOSCO Final Report – An Examination of the Regulatory Issues Arising from CIS Mergers, published November 2004

5 IOSCO Objectives and Principles of Securities Regulation, published June 2010

Chapter 2 – Good Practices for the Termination of Investment Funds

1.4. Disclosure at Time of Investment

Good Practice 1

The responsible entity should disclose, at the time of investment, information relating to the ability to terminate an investment fund as well as the processes for effecting such termination. In this regard, the investment fund documentation should:

i. **outline the general circumstances in which an investment fund can be terminated;**
ii. **set out the extent to which investor approval or consent is required to effect the termination;**
iii. **disclose that when a decision to terminate is made, the responsible entity will prepare a termination plan - the key contents of which shall be communicated to investors;**
iv. **provide a high level overview of the key items that will be covered in the termination plan; and**
v. **set out whether investors may bear the costs of the termination.**

As part of the normal course of business the decision to terminate lies with the responsible entity. The circumstances in which an investment fund may be terminated voluntarily should be disclosed clearly in the documentation of the investment fund. The list of possible reasons for terminating the investment fund does not need to be exhaustive as circumstances will undoubtedly change over time. This should include circumstances where the responsible entity might decide to terminate the investment fund based on factors outside of its direct control. It should also outline whether investor approval or consent will be required to effect termination. Disclosure in the investment fund documentation should seek to address, at a high level, the main reasons why the responsible entity might decide to terminate.

It is important that, as part of that disclosure, an investor is also made aware of the process surrounding the termination of the investment fund as the termination process may limit the investor's ability to exit the investment fund in the normal manner at some future point in time. In particular, the investor should be made aware that a process will exist at the time a decision to terminate is made (as the exact process may depend on the circumstances leading up to the termination).

As terminations are generally outside the control of the investment fund investors, it is considered good practice that the responsible entity prepares a termination plan when the decision to terminate the investment fund is taken. Good Practice 4 deals with the

termination plan in some detail. In summary, the plan should address the different stages of and the practical issues that may arise as part of the termination process. The termination plan should be prepared by the responsible entity when the decision to terminate the investment fund is taken and the contents communicated to investors. Where there is a likelihood that certain factors may impact an investment fund's ability to terminate in an orderly manner, these factors should be clearly disclosed to investors as a risk warning.

Investment fund terminations can be lengthy processes, particularly where there are issues surrounding illiquid securities, suspensions or an inability to make contact with investors. Disclosing a high level overview of the key items that will be covered in the termination plan in the investment fund documentation should inform investors about the various stages of the termination process and assist in managing investor expectations during the termination process.

An important consideration in the termination process is the role of fund distributors and intermediaries in ensuring investors are fully informed about important details concerning their investment in the investment fund. Extensive distribution networks, prevalent particularly in the case of retail investment funds, can complicate the termination process and make it difficult for the responsible entity to ensure information reaches the investor.

In circumstances where the responsible entity does not interact directly with the end investor (e.g. where an investor has invested through a broker or an exchange), the responsible entity should consider how to seek to ensure that the relevant information about the termination process is communicated to the end investor. This may involve putting in place contractual arrangements at the time a distributor is appointed to require the dissemination of information to end investors.

Good Practice 2

Investment fund documentation should set out how the responsible entity will deal with investors who are not contactable at the time a responsible entity decides to terminate an investment fund.

Uncontactable investors present challenges for terminating investment funds. The inability to contact investors can arise when investors fail to notify the investment fund or its service providers of changes to their contact details, address, or bank account details. Having out-of-date investor information can lead to an inability to contact the investor. This delays the investment fund termination process as there is no way of remitting monies due to the uncontactable investor.

The responsible entity's inability to contact an investor should not, after a reasonable period of time, further delay the termination process. It is considered good practice for the

responsible entity to inform investors, at the time of their initial investment, of the problems and consequences of absence of contact over the life-cycle of their investment.

An important consideration is how the responsible entity will treat the proceeds belonging to uncontactable investors. In some cases, the responsible entity will have arrangements in place for the holding of an investor's unclaimed monies until such time as they can be allocated. The responsible entity also should have clear procedures around trying to make contact with the investors.

While the investor should take reasonable care to ensure they avoid loss of contact, the responsible entity should detail within the investment fund documentation (i) the procedure to be applied by the responsible entity when attempting to make contact with investors, (ii) how unclaimed amounts will be treated including duration for which these unclaimed monies will be held, and (iii) the procedure to be followed once this period has elapsed in accordance with the fund's documentation and applicable laws and regulations..

The level of detail and prominence of the disclosure described in paragraph 24 and the procedures which a responsible entity puts in place to limit the risk of losing contact with investors should take into account whether or not there is a national legal or regulatory regime which addresses the treatment of unclaimed redemption monies or distribution proceeds. For example, some jurisdictions have arrangements whereby unclaimed proceeds are held in dormant or unclaimed accounts or alternatively transferred to the courts, the regulator or the state. Others do not, which can make it more difficult and costly for investment funds with uncontactable investors in those jurisdictions to complete a termination process. In providing proper and clear disclosure, a responsible entity in these jurisdictions should have higher levels of detail and more prominent levels of disclosure. They should go further to try to maintain contact with investors.

It is not considered good practice for unclaimed amounts to be transferred in a manner where they cannot be returned to the investor if he or she subsequently appears within a reasonable time period, unless such transfers are required by law. The determination of a reasonable time period varies greatly based on the laws and standards applicable in each jurisdiction. However, where the amounts involved are de minimis, it may be appropriate to transfer these away where they cannot be retrieved and returned to the investor at a later date.

1.5. Decision to Terminate

Good Practice 3

The responsible entity's decision to terminate an investment fund should take due account of the best interests of investors in the investment fund.

The responsible entity has a duty to act in the best interests of investment fund investors, throughout the life of the investment fund. This may be complicated in instances where there are differing investor interests. It may also be further complicated where the particular interests of individual investors are unknown. In these circumstances, the responsible entity should ensure decisions made around the termination are in the best interests of all investors in the investment fund to the fullest extent possible.

Responsible entities decide to terminate investment funds for many different commercial reasons; some investment funds fail to attract significant assets at the outset and cease operations and terminate within a relatively short period of time of initial launch. In other cases, the responsible entity may seek to terminate the investment fund as taking factors such as costs into account, to continue in existence would not be acting in the best interests of investors. In the main, however, a poor track record over a prolonged period of time is one of the primary reasons for investment fund terminations.

For closed-ended investment funds, in particular, terminations also arise where the investment fund has reached the end of its natural life and seeks to wind-up and distribute redemption proceeds to investors in line with its investment objective. Once final distributions have been made, the closed-ended investment fund will terminate.

Conflicts may arise for the responsible entity in managing the commercial motivations for investment fund terminations on the one hand and interests of investors on the other. Similar to all other actions of the responsible entity, the responsible entity should be able to demonstrate that the decision to terminate has taken due account of the interests of investors in the investment fund.

Good Practice 4

Following a decision to terminate an investment fund, the responsible entity should issue a termination plan. This should set out the steps to be taken during the termination process and should take into account the best interests of investors. The termination plan should contain, depending on the legal form of the investment fund, information relating to the following key items as appropriate:

i. **the rationale for terminating the investment fund;**
ii. **the process for obtaining investor approval to effect the termination, if required;**
iii. **an estimation of the costs of the termination and whether investors will bear these;**
iv. **whether another entity will be appointed to effect the termination (e.g. a liquidator);**
v. **the estimated duration of the termination process and how information will be communicated to investors throughout;**
vi. **the existence of alternative investment opportunities (including mergers, or transfers to other investment products), if any;**
vii. **investor dealing arrangements (including the necessity for suspension of subscriptions and redemptions) in the investment fund;**
viii. **an indication of the asset valuation method (including illiquid or hard to value assets) of the investment fund;**
ix. **the process for dealing with illiquid assets or addressing any windfall payments due to the fund and its investors after the fund is terminated.**

The termination plan should specify in reasonable detail each of the applicable steps that will be required in order to terminate the investment fund. The termination plan is an important tool that enhances investor understanding and knowledge of the termination process and facilitates a smooth and orderly termination. It will not seek to replace or circumvent the provisions of national law or regulation.

The reference to 'issue a termination plan' should be taken to mean either (a) the full termination plan being communicated to investors or (b) a summary of the termination plan being communicated to investors with the full document available on request. This gives responsible entities the flexibility to determine the appropriate level of detail to communicate to investors.

Where a summary of the termination plan is provided to investors, it would be appropriate to disclose the following information at a minimum - (i) the estimated duration; (ii) investor

dealing arrangements from date of notification; and (iii) whether investors will bear the costs of the termination.

The termination plan should identify the rationale for terminating the investment fund. It should also identify the key steps that will be taken as part of the termination process.

In the majority of cases, the decision to terminate is that of the responsible entity. However, in some jurisdictions national law or regulatory requirements will mandate that the decision of the responsible entity is approved by investors, or the custodian in some cases. The first step in preparing for the voluntary termination of an investment fund is to determine whether investor approval is required. This may depend on the legal structure of the investment fund and whether voting rights are attributed to shares / units.

Investment in an investment fund usually carries with it the right to vote on certain matters and the voting requirements for the approval of investors on, *inter alia*, liquidations and terminations are generally prescribed in the constitutional documents and the offering documentation of the investment fund, or legal and regulatory regime of the national regulator, or both. The termination plan should set out the process for obtaining investor approval, where required.

Where investor approval is required and investors are asked to vote on the decision to terminate with the outcome achieving the minimum voting requirements for approval, the decision should be binding on all, including those who do not vote. Where investor approval is required, the rights of investors should be clear from the termination plan. This should reflect the information originally communicated to investors in the offering documentation. In particular, the termination plan should document how the interests of dissenting investors will be treated.

In the majority of cases for voluntary terminations, the cost of termination will be borne by the investment fund, and ultimately the investors. The responsible entity should communicate to investors an estimate of the costs involved in terminating the fund and who will pay these. The estimated costs should take into account all costs associated with the appointment of a liquidator or other agent, if applicable. In the context of open-ended investment funds, the costs of the termination should be estimated as soon as possible to ensure they are reflected in the net asset value of the investment fund.

While the termination process is the responsibility of the responsible entity, it may employ the services of a liquidator to realise the value of assets and facilitate the termination process. The responsibilities of the liquidator also include the coordination, communication and management of the interests of all investment fund investors. The termination plan should state if another entity will be appointed (e.g. a liquidator) to the investment fund to complete the termination process and in what circumstances such an entity would be appointed.

The termination plan should provide an estimated duration for the termination process.

The responsible entity should ensure that the termination plan sets out how it will communicate with investors during the termination process. Moreover, the termination plan should disclose whether the responsible entity will be in a position to provide regular updates to investors (for example, due to the appointment of a liquidator). If this is not possible, the termination plan should detail the form and frequency of investor communication to be expected from the liquidator.

The termination plan should provide that the responsible entity will consider whether it is appropriate to offer investors alternative investment opportunities such as mergers, or transfers into other investment products or other investment funds with similar investment strategies. Where the responsible entity is offering investors alternative investment opportunities such as mergers, or transfers into other investment products or other investment funds with similar investment strategies, this should also be clearly disclosed.

The termination plan should detail whether investors may redeem their interest in the investment fund in advance of the formal commencement of the termination process.

In the majority of cases, the termination process should be a straightforward matter and facilitated in a reasonably short period of time. Some jurisdictions prescribe timeframes for the orderly wind-up and termination of an investment fund. However, issues concerning illiquid or hard to value assets, suspensions, delays by external service providers, etc., can impact on the ability of an investment fund to terminate in a timely or orderly fashion.

While it is difficult to ascertain to any degree of accuracy when illiquid securities will recover in value, for example, or when the portfolio has been liquidated in full and suspensions can be lifted, it is important to manage investor expectations and is considered good practice to keep investors informed of the progress on these matters.

Illiquid securities tend to be hard to value with limited or no active secondary market. Illiquid securities can have a direct impact on the liquidation of assets and can significantly delay the termination of the investment fund.

Where the illiquid assets cannot be disposed of at fair value, in some jurisdictions investment funds are permitted to value these assets at nil; the proceeds from the sale of all other assets within the portfolio will then be distributed among investors. The investment fund is then terminated. In some cases, the investment fund custodian is responsible for holding the illiquid assets until such time as a value is realised. In other cases, the responsible entity may side-pocket relevant assets or may be required to realise the value of the asset on the termination day, either by purchasing the asset itself or for the benefit of other investment funds under its management. In the main, however, the termination process is typically

delayed until such time as all assets can be valued and liquidated. Ultimately, disposing of the assets at nil value should be a solution of last resort.

While it is acknowledged that jurisdictions require all investment funds to provide for fair value in accordance with their valuation policies, there could be an incentive for the responsible entity to expedite the termination process and sell illiquid or hard to value assets at a price less than the last known market price or fair value price. In some jurisdictions, the responsible entity may apply a discount on the sale of securities in the case of stressed markets. Where this is possible the responsible entity should provide proper disclosure in the investment fund documentation on the ability to apply a discount and the circumstances in which this practice is permitted.

The responsible entity should have procedures in place for the valuation of illiquid securities and these procedures should be disclosed to investors as part of the valuation policy in the investment fund documentation or alternatively disclosed in the termination plan. The responsible entity should take all reasonable steps to obtain the best possible outcome for the investment fund investors, taking into account price, costs, likelihood of execution and size amongst other factors. Ultimately it is a matter for the responsible entity to manage appropriately as the circumstances for termination are not identical in all cases.

The responsible entity should determine the appropriate time and price to sell a security, while ensuring at all times that it acts in the best interest of investors. In cases where the shareholder base of the investment fund comprises retail and professional investors, there may be conflicting views as to the perceived best interests of all investors. Such decisions can be difficult to resolve and are generally matters for the responsible entity to determine, unless local laws require otherwise.

When considering the matter of illiquid securities, it is also necessary to take into account the appropriate treatment of proceeds recovered from the sale of securities which were once deemed illiquid i.e. windfall payments or delayed reclaims of foreign withholding tax. While most legal or regulatory regimes do not have specific rules for the treatment of windfall payments, it is a good practice to distribute proceeds from windfall payments on a best efforts basis by the responsible entity and attributed pro rata to the investors in the investment fund at the time of termination.

The treatment of windfall payments can present administrative challenges as it requires proper records to be maintained indefinitely by the responsible entity or the custodian. In most cases these service providers would not be accruing a fee for this service; moreover, it binds them to holding the asset and the records of the investment fund for an indefinite period of time. In circumstances where service providers are entitled to recoup fees for the holding and distribution of proceeds, these costs would likely be passed on to investors at such time

as the assets are realised. The termination plan should set out whether service providers can accrue a fee so that there is clarity and consistency for investors.

Subject to a de minimis amount remaining, the authorisation of an investment fund should not be revoked until such time as all assets have been realised or are no longer assets of the investment fund. Where a de minimis amount remains, this should not prevent the investment fund from revoking its authorisation.

In some jurisdictions, where investor consent has been received or where the realisation of assets remains subject to regulatory supervision, the investment fund may switch to become an unregulated fund structure in advance of termination.

Noting the difficulties surrounding this process, it is considered good practice for the responsible entity to document how it proposes to address windfall payments and the process of the responsible entity should be disclosed to investors.

Good Practice 5

Taking into account the applicable regulatory framework, the responsible entity should consider suspending investor subscriptions and redemptions during the termination process of an open-ended fund with a view to protecting the interests of investors.

Upon approval of the termination, open-ended investment funds frequently suspend subscription and redemptions to facilitate an orderly wind-up. The criteria governing the suspension of subscriptions and redemptions of an investment fund are prescribed in the investment fund documentation. It should be noted, however, that some jurisdictions do not permit an investment fund to suspend redemptions absent the approval of that jurisdiction. In these cases, the decision to suspend redemptions should take into account the applicable jurisdiction's regulatory framework.

Where investment funds are terminating, early redeemers may seek to redeem their interests in advance of the formal termination process in order to profit from the most favourable liquidity conditions, thus passing the liquidity cost to remaining investors (i.e. a 'first mover advantage'). The responsible entity may opt to suspend subscriptions and redemptions following the decision to terminate, to eliminate the risk of first mover advantage. By suspending subscriptions and redemptions, the responsible entity seeks to minimise the risk of liquid assets being sold at the outset before being obliged to dispose of less liquid assets, and thereby incurring higher liquidity costs for remaining investors later on in the process. Other liquidity management tools play a role in reducing the dilution effect from these higher liquidity costs, but a suspension of dealing seeks to ensure that first mover advantage is fully mitigated.

The termination plan should disclose whether the responsible entity will suspend subscriptions and redemptions after deciding to terminate. Where the responsible entity may opt not to suspend subscriptions and redemptions, the termination plan should outline the reasons and the rationale behind such instances. While it may be possible in some jurisdictions to continue to facilitate subscription and redemption requests, the responsible entity should ensure the fair treatment of all investors (for example, by making adequate provisions for the termination costs in calculating the pay-outs to the redeeming investors). The timing of the decision to terminate and the decision to suspend should be considered by the responsible entity so that it does not, inadvertently or otherwise, create opportunities which facilitate first mover advantages for investors. The termination plan should clearly document the policy of the responsible entity and the measures taken to address the issue in relation to first mover advantage and the sale of liquid assets to meet early redemption requests.

Good Practice 6

The responsible entity should approve the termination plan. The board of the investment fund, or, if no such board exists, the third party responsible for independent oversight should also approve the termination plan.

The termination plan should be subject to appropriate governance and oversight to ensure the best interests of investors have been properly considered. Therefore, the responsible entity should approve the termination plan. As an additional layer of governance, the board of the investment fund, or if no such board exists, a third party responsible for independent oversight6 should also approve the termination plan. Ultimately, the responsible entity should maintain clear open lines of communication with relevant parties to seek to ensure they are engaged and constructive during the termination process.

The national regulator should be notified of the investment fund termination and, in some cases, it may be appropriate for the national regulator to approve the termination plan. This would provide the national regulator an opportunity to request further information before the responsible entity proceeds. This process, however, should not overly impede or delay the liquidation process to the disadvantage of investors.

6 For example, a custodian.

1.6. Decision to Merge

Good Practice 7

The responsible entity should clearly communicate to investors the decision to merge an investment fund with another investment fund.

There are many advantages for the responsible entity when a merger of two investment funds occurs. Investment fund mergers allow responsible entities to rationalize their range of investment funds, particularly where the merger involves investment funds with similar investment objectives and policies. There are also benefits for investors when investment funds merge as they can often result in a reduction of costs and/or better performance due to greater economies of scale. Investment fund mergers may also occur when the investment fund is not economically viable on its own and has failed to accumulate sufficient asset size.

When planning to effect a merger of two investment funds, the responsible entity should provide investors in the discontinuing fund with sufficient information to enable them to evaluate the merger proposal and make an informed decision as to whether they wish to proceed with this option.

The responsible entity should also provide investors with information on the background and rationale for the proposed merger, the investment objective and risk profile of the receiving investment fund, details of the service providers, details of entry and exit fees (those fees not associated with the merger itself) along with an indication of all ongoing costs/charges associated with investment.

Disclosure to investors should also include details of how the merger will be effected, i.e. whether investors are required to vote on the proposal, the timeframe and minimum voting requirements to approve the merger and the proposed treatment of dissenting or non-voting investors. This communication should also include information on the procedure for the transfer of assets and exchange of shares/units. Any information provided to investors must be accurate, well balanced and not misleading.

Good Practice 8

To the extent possible, the responsible entity should only offer investors the option to merge where the receiving investment fund has similar investment objectives, policies and risk profile to the terminating investment fund.

Investment fund mergers should ideally involve the amalgamation of investment funds with similar investment objectives. This may not always be the case, however, and there are cases where the receiving investment fund has very different investment and risk strategies. In this instance, a merger may result in certain investors being in an investment fund which may not

be suitable for them. Where this is permitted by national regulation, it is necessary for investors to re-evaluate whether the merged product fits their investment objective and risk appetite. Moreover, it is the responsible entity's role to ensure that the merger is and will be undertaken at all times in accordance with the best interests of investors.

Good Practice 9

The responsible entity should offer investors the right to redeem free of redemption or exit charges before the merger takes place. Investors should be informed of the available alternatives sufficiently in advance.

In the majority of cases, merger proposals are presented to investors for their approval by way of a vote. Investors should be informed of the terms and conditions of the mergers and afforded a specified period of time to consider the proposal in advance of the vote. It is considered good practice, before a merger becomes effective, for the responsible entity to offer investors the possibility to redeem their shares without redemption or exit charges (except where any anti-dilution mechanism is applied to the dealing price).

Good Practice 10

The responsible entity should incur all legal, advisory and administrative costs related to a merger. Where the responsible entity proposes not to incur these costs, this decision should be documented in the investor communication including a rationale for the decision.

Mergers should only be proposed where this is in the best interests of investors. Mergers typically result in legal, advisory, administrative fees and expenses being incurred. In cases where the responsible entity does not intend to incur the costs of the merger and instead investors will bear these, this decision should be clearly disclosed in the investor communication and include a clear rationale for non-payment by the responsible entity and how this is consistent with acting in the best interests of investors. Where investors are expected to bear the costs of the merger, this may be subject to approval from the regulator in some jurisdictions. In any event, the responsible entity should ensure that investors are treated fairly.

1.7. During the Termination Process

Good Practice 11

The responsible entity should ensure that appropriate / adequate information about the termination process is communicated to all investors concurrently and in an appropriate and timely manner. Investors should be kept up to date as circumstances change.

Investor communication is very important throughout the termination process. Investment fund terminations can be prolonged processes spanning in excess of one year.

Information should be communicated simultaneously to all direct investors in an appropriate manner to ensure their fair treatment. The responsible entity should also consider the information needs of intermediate or indirect investors as well as other key stakeholders including service providers and regulatory bodies.

Where a liquidator is being appointed, the responsible entity should, to the extent known, communicate to investors whether it will be in a position to provide regular updates to investors and/or the form and frequency of investor communication to be expected from the liquidator.

Investor communication should include, *inter alia*, the following:

- The outcome of any investor approval process, i.e. whether the termination will proceed or not;
- Whether the investment fund will facilitate redemptions up to the commencement of the termination process and whether a redemption cost will be levied on such transactions;
- Whether subscriptions and redemptions will be suspended after termination commences, with an indication of the duration of any such suspension;
- When investors can expect to receive updates on the progress of the termination process;
- Expected date of termination;
- The process for liquidation of portfolio securities;
- The expected timeframe for payment of final distribution proceeds from the sale of investment fund assets to investors.

Appointment of a liquidator may depend on the legal structure of the investment fund e.g. corporate investment funds may require liquidators whereas investment funds structured under trust law may not. In general, once a liquidator has been appointed, the investment fund and its responsible entity will have little involvement or discretion in relation to the

management of the investment fund. Moreover, the investment fund and its responsible entity will have limited or no access to information on the financial standing of the investment fund, the composition of the portfolio or the current asset valuation of the investment fund. It may be difficult therefore, for the investment fund or its responsible entity to comply with normal communication requirements to investors during this time.

During the termination process, the main focus of the responsible entity should be to realise the investment fund's assets and distribute the proceeds while ensuring fair treatment of all investors. In light of this, it may not be possible or feasible to meet the investment objective, investment policies and restrictions of the investment fund at that time. However, the responsible entity should always seek to act in the best interests of investors. It should refer to these matters in its communications with its investors and the third party responsible for independent oversight, if applicable.

National laws in some jurisdictions exempt liquidators from the requirement to provide information to investors in an investment fund. In other jurisdictions, while no regulatory requirements exist for liquidators to provide information to investors, company/corporate laws in the relevant jurisdictions may require the liquidator to provide information to investors on the status of the liquidation process. Typically, the liquidator should present to investors on an annual basis why the liquidation has not been completed.

Good Practice 12

In valuing the assets of the terminating investment fund, the responsible entity should -

i. **ensure that fair valuation of the assets will apply, and**
ii. **seek to address conflicts of interest arising.**

Assets should be valued according to current market prices and in a manner consistent with the local laws, constitutional documentation and prospectus / offering document of the fund, provided that those prices are available, reliable and frequently updated. It is critically important that an investment fund values all assets in its portfolio, including those assets for which market quotations are not readily available.

All investment funds and their responsible entities should have written policies and procedures setting out the methodology to be used for valuing each type of asset within the portfolio in normal and exceptional circumstances including cases of termination. The valuation policies should be sufficiently robust to permit the investment fund to make adjustments to the valuation policy where it is considered necessary to reflect fair value. The rationale for adjusting the value should be clearly disclosed.

The IOSCO *Principles for the Valuation of Collective Investment Schemes*,[7] Principle 3 states that "[t]he valuation policies and procedures should seek to address conflicts of interests".

The potential for conflicts of interest regarding the valuation of an investment fund's portfolio assets can arise in a number of ways. The potential for conflicts of interest could be seen as higher in the context of illiquid or hard to value assets where the responsible entity is, in practice, the most reliable or only source of information about the pricing of particular assets. The responsible entity may be inherently conflicted with regard to the valuation process as its fees are calculated on the basis of the value of the investment fund assets. The responsible entity may also be conflicted regarding the other funds it manages in comparison with the one being terminated. A responsible entity might consider terminating a fund in order to favour one of the other funds it manages. In all cases, managing conflicts of interests passes through to the responsible entity to ensure that the decision to terminate a fund is based on legitimate reasons and that the valuation process does not favour one fund at the expense of another.

While the responsible entity must act in the best interests of investors at all times, in the case of an investment fund that is winding up or seeking to terminate, there may be a further incentive for the responsible entity to delay the sale of an asset in anticipation of a higher realised value at some future stage. This could give rise to possible conflicts of interest.

1.8. Specific types of Investment Funds

This section seeks to address specific issues for real estate, hedge funds, private equity funds and other funds that would not typically be offered for sale to retail investors and are more likely to hold illiquid or hard to value assets.

Good Practice 13

The responsible entity may offer institutional investors in a terminating investment fund the ability to redeem *in specie* where the consent of the investor has been obtained, while ensuring the best interests of other investors in the investment fund are not jeopardised.

Principle 4 of IOSCO *Principles on Liquidity Risk Management in Collective Investment Schemes* [8] states "[w]here permissible and appropriate for a particular investment fund, and in the interests of investors, the responsible entity should include in the investment fund's

[7] IOSCO Final Report – Principles for the Valuation of Collective Investment Schemes, published May 2013

[8] IOSCO Final Report – Principles of Liquidity Risk Management for Collective Investment Schemes, published March 2013

constitutional documents the ability to use specific tools or exceptional measures which could affect redemption rights".

The explanatory text for this principle refers to *in specie* redemptions as an example of one such tool which may be used. *In specie* transfers may be used to pay wholly or in part investor redemption proceeds. *In specie* transfers involve transferring ownership of a proportionate share of the underlying assets directly to redeeming investors, usually so that the investor receives a pro-rata share of each asset comprising the portfolio although this may be impractical in some cases, such as debt instruments with large values. The IOSCO *Principles on Liquidity Risk Management for Collective Investment Schemes* state that the use of *in specie* redemptions may not be practical or appropriate for retail investors. Often it is the case that retail investors will not have the appropriate infrastructure (e.g. custody accounts and verification processes) to support the transfer and holding of assets if executed *in specie*. This is in addition to the risks prevalent, which include the fact that the instrument is likely illiquid in the first instance.

There are a number of advantages for the responsible entity to using *in specie* transfers to progress the wind-up and termination of an investment fund holding illiquid securities:

- the investment fund will not be required to hold the illiquid security for an indefinite period;
- the investment fund can terminate, thus eliminating the need to comply with its legal or regulatory obligations during the winding-up phase;
- the investment fund and its investors are not incurring the cost of the service providers mandated to hold and manage the illiquid security.

However, concerns could be raised regarding the appropriateness of transferring ownership of an illiquid security to the underlying investor where the investor then assumes responsibility for managing the sale of the asset and also assumes the risk of not realizing its investment.

As a good practice, the responsible entity should only offer investors redemptions *in specie* where the institutional investor has consented to this arrangement. The responsible entity should consider whether it could arrange the sale of the asset on behalf of the investor if requested.

Good Practice 14

In the context of a fund of finite duration, the responsible entity should, within a reasonable period in advance of the fund's anticipated termination date, consider the procedures that will be required to achieve an orderly and timely wind-up of the fund.

Funds of finite duration are typically of a closed-ended nature with a defined termination date, although some structures may permit an extension (for example, upon receipt of shareholder approval).

At the inception of a fund of finite duration, the responsible entity will have a relatively precise knowledge of the date on which it expects the fund to terminate. With this in mind, it would be expected that the responsible entity should, within a reasonable period in advance of the termination date, be in a position to consider and document its approach to liquidating the open positions of the fund and distributing the proceeds to investors. This should be done while seeking to ensure that the over-arching obligation of maintaining the best interests of investors is considered throughout.

1.9. Appendix – List of Good Practices

Disclosure at Time of Investment	
Good Practice 1	The responsible entity should, at the time of investment, disclose information relating to the ability to terminate an investment fund as well as the processes for effecting such termination. In this regard, the investment fund documentation should: i. outline the general circumstances in which an investment fund can be terminated; ii. set out the extent to which investor approval or consent is required to effect the termination; iii. disclose that when a decision to terminate is made, the responsible entity will prepare a termination plan - the key contents of which shall be communicated to investors; iv. provide a high level overview of the key items that will be covered in the termination plan; and v. set out whether investors may bear the costs of the termination.
Good Practice 2	Investment fund documentation should set out how the responsible entity will deal with investors who are not contactable at the time a responsible entity decides to terminate an investment fund.
Decision to Terminate	
Good Practice 3	The responsible entity's decision to terminate an investment fund should take due account of the best interests of investors in the investment fund.
Good Practice 4	Following a decision to terminate an investment fund, the responsible entity should issue a termination plan. This should set out the steps to be taken during the termination process and should take into account the best interests of investors. The termination plan should contain, depending on the legal form of the investment fund, information relating to the following key items as appropriate: i. the rationale for terminating the investment fund; ii. the process for obtaining investor approval to effect the

	termination, if required; iii. an estimation of the costs of the termination and whether investors will bear these; iv. whether another entity will be appointed to effect the termination (e.g. a liquidator); v. the estimated duration of the termination process and how information will be communicated to investors throughout; vi. the existence of alternative investment opportunities (including mergers, or transfers to other investment products), if any; vii. investor dealing arrangements (including the necessity for suspension of subscriptions and redemptions) in the investment fund; viii. an indication of the asset valuation method (including illiquid or hard to value assets) of the investment fund; ix. the process for dealing with illiquid assets or addressing any windfall payments due to the fund and its investors after the fund is terminated.
Good Practice 5	Taking into account the applicable regulatory framework, the responsible entity should consider suspending investor subscriptions and redemptions during the termination process of an open-ended fund with a view to protecting the interests of investors.
Good Practice 6	The responsible entity should approve the termination plan. The board of the investment fund, or, if no such board exists, the third party responsible for independent oversight should also approve the termination plan.
Decision to Merge	
Good Practice 7	The responsible entity should clearly communicate to investors the decision to merge an investment fund with another investment fund.
Good Practice 8	To the extent possible, the responsible entity should only offer investors the option to merge where the receiving investment fund has similar investment objectives, policies and risk profile to the terminating investment fund.

Good Practice 9	The responsible entity should offer investors the right to redeem free of redemption or exit charges before the merger takes place. Investors should be informed of the available alternatives sufficiently in advance.
Good Practice 10	The responsible entity should incur all legal, advisory and administrative costs related to a merger. Where the responsible entity proposes not to incur these costs, this decision should be documented in the investor communication including a rationale for the decision.
During the Termination Process	
Good Practice 11	The responsible entity should seek to ensure that appropriate / adequate information about the termination process is communicated to all investors concurrently and in an appropriate and timely manner. Investors should be kept up to date as circumstances change.
Good Practice 12	In valuing the assets of the terminating investment fund, the responsible entity should - i. ensure that fair valuation of the assets will apply, and ii. seek to address conflicts of interest arising.
Specific Types of Investment Funds	
Good Practice 13	The responsible entity may offer institutional investors in a terminating investment fund the ability to redeem *in specie* where the consent of the investor has been obtained, while ensuring the best interests of other investors in the investment fund are not jeopardised.
Good Practice 14	In the context of a fund of finite duration, the responsible entity should, within a reasonable period in advance of the fund's anticipated termination date, consider the procedures that will be required to achieve an orderly and timely wind-up of the fund.