

## ICMA AMIC Response to CIS Liquidity Risk Management Recommendations

### Introductory Comments

1. The ICMA Asset Management and Investors Council ('AMIC') was established in March 2008 to represent the buy-side members of the ICMA membership. ICMA is one of the few trade associations with a European focus and both buy-side and sell-side representation. AMIC welcomes the opportunity to respond to this consultation by the International Organization of Securities Commissions (IOSCO) on CIS Liquidity Risk Management Recommendations.
2. AMIC has a long-standing engagement with regulators on fund liquidity risk management. AMIC has responded to three FSB/IOSCO consultations touching on this topic among others, in [2014](#), [2015](#) and [2016](#). AMIC has also jointly with the European Fund and Asset Management Association (EFAMA) drafted a [research report](#) on liquidity risk management in investment funds and more recently a [research report](#) on leverage in investment funds.

### General comments

3. We agree that IOSCO is the appropriate regulatory forum to analyse systemic risk.
4. We are generally supportive of IOSCO's recommendations, but in a few areas we believe that there is an over-reliance on ex-ante measures such as product design or stress testing, which, when taken with the "extreme but plausible" scenarios outlined could lead to a situation where investors may have a false sense of security.
5. We would prefer some consideration to a holistic tool-set, including more ex-post tools and a general acceptance that there are some market situations that no amount of contingency planning can cope with without severely limiting the investable universe for funds.

### Responses to questions and comments on recommendations

#### General question

##### Question 1

*- The 2013 Liquidity Report related to open-ended CIS and where determined by the responsible entity, to some closed-ended CIS. Should the proposed text laid out below apply also to the same range of CIS? Should certain CIS or types of CISs be excluded from any particular requirements, or be subject to a different requirement, because of their investment strategies, ownership concentrations, redemption policies, or some other factor that makes them more or less prone to liquidity risk?*

6. We do not believe that there have been significant problems with how the 2013 liquidity guidelines were implemented across IOSCO's members. Therefore, we believe the 2017 liquidity guidelines should be applied to the same range of CIS as the 2013 ones. In other words, the 2017 guidelines should apply to all open-ended CIS and, where the responsible authority so chooses, some closed-ended CIS.
7. However, the focus of the Recommendations should be on open-ended CIS. There are many types of dealing cycles in open-ended funds ranging from daily dealing funds to funds open for dealing on a quarterly or six-monthly basis or indeed funds which are open for redemption on a limited basis. We do not support an overly prescriptive statement of whether or not a particular type of

CIS should be required to use a specific set of tools. We recommend a proportionate approach to the application of the recommendations.

### Good Practices Document

#### Question 2

*- Do respondents agree with the general considerations around liquidity risk management? Are there other issues that should be included?*

8. Yes, we agree with the general considerations and we do not believe there are other issues that need to be included. In particular, we support the statement that the primary responsibility for liquidity risk management lies with the asset manager

#### Question 3

*- Does the Good Practices Document cover the key considerations regarding liquidity risk management tools, including their use in normal and stressed scenarios? Are there other issues that should be considered? Are there other key tools that should be included? Do you agree with the pros and cons in regards to the use of each tool? Are there other pros and cons that should be considered?*

9. Yes, we believe that the Good Practices Document covers the key scenarios and use of liquidity risk tools. We welcome that IOSCO has considered the AMIC/EFAMA research report on liquidity risk management, which focused particularly on the comprehensive existing regulations and practices around liquidity risk management in Europe. As we have noted in that report, we would support greater harmonisation of the availability of liquidity management tools across jurisdictions.

#### Question 4

*- Do you agree with the general considerations regarding stress testing? Are there other issues that should be included?*

10. Yes, we agree with the general considerations on stress testing. We particularly agree with the recognition of the comprehensive rules on stress testing set out in EU legislation such as AIFMD applicable to fund managers. It is important to emphasise that stress testing needs to be conducted at the level of individual funds.
11. We are supportive of IOSCO not recommending stress testing across all open-ended CIS. Open-end CIS are heterogeneous, pursuing disparate investment strategies. A macro stress test across funds that does not account for the diversity of funds in a given sector and incorporate performance of different sectors and sub-sectors as well as the diversity of investors is unlikely to produce results that are reflective of potential market dynamics. This is particularly true if such models assume all shareholders in all types of CIS react to market stress in the same way.
12. We support the provision of guidance on stress testing for individual open-end funds. However, when considering stress testing of funds, it is important to remember that the concept of liquidity stress testing of funds is quite different from, and should not be conflated with, stress testing of banks. In particular, open-ended funds do not guarantee the value of fund shares or employ significant leverage, requiring different risk management solutions. Unlike banks, which have an obligation to meet deposit liabilities, mutual fund redemptions are executed on a pro rata share of the value of the securities held in the fund, with no guarantee of a particular price. These important differences between bank deposits and open-

end funds must be considered when applying liquidity stress testing to funds. In addition, the assets of CIS are typically held by independent custodians who are separately liable for loss of the fund assets.

13. Open-ended fund managers must manage fund assets in the best interests of all investors in the fund. This often results in funds maintaining some amount of borrowing capacity to address tail risk redemption scenarios, while at the same time seeking to meet redemptions through pro rata or risk constant selling of fund assets during the majority of circumstances to avoid creating situations where the fund's assets become materially less liquid as a result of redemptions. Likewise, fund managers should seek to avoid situations where fund assets need to be sold at "fire sale" prices in order to meet redemptions. Liquidity risk stress testing is one tool that can be helpful to ensure fund managers are maintaining appropriate liquidity. Another important area for consideration when developing guidance related to stress testing of individual funds is that such guidance must carefully balance what might be theoretically ideal versus practical reality.

#### ETF questions

##### Question 5

*- Should ETFs be subject to different liquidity requirements than other CIS?*

14. No, we do not believe ETFs should be subject to different liquidity requirements than other CIS. Liquidity issues and stressed markets impact all funds. We have seen global events that have led to the application of gating to non-exchange traded UCITS. As such any discussion of stressed markets should be viewed in the context of impacting all fund types and not simply ETFs.
  - a) If not, should ETFs be included within the scope of the 2017 Liquidity Recommendations?
15. We believe ETFs should be included in the scope of the 2017 liquidity recommendations.
  - (i) If yes, are changes needed to be brought to the 2017 Liquidity Recommendations to reflect ETFs specificities? Which ones?
16. No, no specific changes are needed.
  - (ii) If not, please explain why ETFs should not be included within the scope of the 2017 Liquidity Recommendations if they have partly similar liquidity issues as other CIS.
17. Not relevant as we believe ETFs should be included in the scope of the 2017 Liquidity Recommendations.
  - b) If ETFs should be subject to different liquidity requirements than other CIS, what should they be?
18. We do not believe that ETFs should be subject to different liquidity requirements.

##### Question 6

*- Are there key liquidity related issues specifically regarding ETFs?*

19. We refer to the recent [Discussion Paper by the Central Bank of Ireland on ETFs](#), which raised many important aspects of ETFs and their potential impact on liquidity of assets, and the particular liquidity conditions relevant to redemption and subscription to ETFs through the exchange traded shares. In [our response](#), we stressed the need to take into account the [2012 ESMA Guidelines on ETFs and other UCITS issues](#).

## The proposed additional guidance and recommendations

### Existing Recommendations

#### Question 7

- Does this guidance on the design phase process capture the best of current good practices in the design of CIS?

20. Yes, however, we would propose some targeted amendments to the proposed texts of Recommendations 3 and 4, outlined below.

#### Recommendation 3

***The responsible entity should carefully determine a suitable dealing frequency for units in the CIS***

*“Deciding that a CIS should be open-ended and the terms on which it is open-ended (to the extent the applicable law and regulation allows such discretion) is a significant design decision to be made. ~~Often responsible entities may be subject to market pressure to provide very frequent dealing options when designing open-ended CIS even when they wish to invest in assets which are, or are likely to become, less liquid.~~ Responsible entities should give due consideration to the structure of the fund and the appropriateness of the dealing frequency having regard to the target investor base, the investment strategy and objectives and also the expected liquidity of the assets. The investment strategy and objectives should be designed to give ~~strong~~ reasonable assurance that redemptions can be met in both normal and reasonably foreseeable (i.e. extreme but plausible) stressed market conditions.”*

21. The deleted sentence above should not be in the Guidance as it is speculative, does not take into account the design-phase and operational-phase tools in place to manage liquidity risk, and is not a Recommendation at such (but a mere comment) in any case.
22. Given our general comment about a potential for a false sense of security among investors, we would prefer reasonable to “strong” assurance in this recommendation.

#### Recommendation 4

***“The responsible entity should ensure that the CIS’ dealing (subscription and redemption) arrangements are appropriate for its investment strategy and underlying assets throughout the entire product life cycle, starting at the product design phase***

*The initial design of a CIS presents an opportunity to put arrangements in place to underpin effective liquidity risk management. CIS should be designed so as to facilitate redemption objectives and other commitments being met and, if that cannot be done in a particular situation, the situation being managed in a prudent and orderly fashion which is in the best interest of investors.*

As part of the initial design process for open-ended CIS, ~~an documented~~ assessment should be conducted of the liquidity risks likely to face the CIS, having regard to its proposed investment strategy, its target investors (as available to the responsible entity) and the assets and instruments it is intended to invest in. The assessment should set out why the relevant design features of the proposed CIS constitute an appropriate structure within which to manage liquidity risk in both normal and reasonably foreseeable stressed market conditions.

This should include consideration as to the quality of information about the investor base which is made available by different distribution channels for the CIS.

Given the importance of design decisions, the assessment should be subject, where appropriate, to an internal approval process at a senior management and/or board level within the responsible entity. ~~where it~~ The fund liquidity risk can be subsequently monitored on an ongoing basis, and therefore the set-up of monitoring tools can be reviewed and updated by both portfolio management and risk management teams.

#### **Liquidity Risk Management Practices - Liabilities**

There should be due regard in the design process, based on market knowledge and other information reasonably available to the responsible entities, to the likely behaviour of target investors. As such, responsible entities should seek to engage with constituent elements of the distribution chain to take reasonable steps to improve their understanding of the underlying type of investors and the behavioural characteristics associated with such relevant types of investors.

#### **Liquidity Risk Management Practices - Assets**

In carrying out the design phase process, there should be due regard to the current and historical liquidity of the assets and instruments to be invested in, and where applicable, to the impact of limits which could be set, including limits on illiquid assets, concentration of assets, individual counterparty risk, CIS size, trading, limits on time allowed to correct unintended limit breaches and any other limits which could be imposed. Risk appetite of target investors should also be taken into account.

#### **Liquidity Risk Redemption-constraining 'Additional Liquidity Management Tools'**

Having completed the design phase analysis of liquidity of the proposed assets, the characteristics of target investors and the features of every-day liquidity management practices, the responsible entity should consider in the design of the CIS an appropriate range of additional liquidity management tools for managing redemptions to assist in the management of stressed market conditions, subject to applicable law and regulation and any regulatory requirements and provided it is in the best interest of unit-holders within the CIS.

23. We believe the guidance to require “documented” assessments is excessive if it were to be applied to all types of funds, particularly when the recommendation itself requires “appropriate” dealing arrangements.
24. Similarly, an addition of “where appropriate” would reinforce this in the fourth paragraph of the proposed guidance.
25. Finally, the suggestion in the guidance that the assessments of all ongoing reviews and updates for all funds should be continuously submitted to the board is too onerous, so our suggested change would require an initial assessment to be reviewed by the senior

management and/or the board and subsequently managed by risk management and portfolio management teams. Such wording would be more proportionate and representative of current regulatory practices.

#### Question 8

- Does Recommendation 7 capture appropriate additional liquidity disclosures?

26. Not completely, we have proposed a few drafting amendments that we hope IOSCO will consider. In general, while we agree with the need to disclose the liquidity risk of the fund, the tools available and a general outline of when these might be used, we would not want to include anything prescriptive in the prospectus which might limit our members' flexibility to deal with changing market dynamics.

#### Recommendation 7

*Additional guidance:*

*"The relevant disclosures concerning liquidity of the CIS should be properly designed taking into account the nature of the assets the CIS intends to invest in and the degree of sophistication of the investor profile.*

*Disclosures concerning liquidity have the potential to provide investors with information to determine whether their liquidity risk appetite matches the liquidity risk profile of the CIS. In particular, such disclosure is most likely to be beneficial where the CIS is invested in assets or instruments which have a record of significantly varying liquidity across the financial cycle or where there is insufficient historical evidence to assess whether liquidity will vary significantly across the financial cycle.*

*Additional disclosure requirements to investors may include one or more of the following:*

- *A clear 'liquidity risk' assessment in the initial offering documentation for the CIS setting out an assessment of the likely liquidity risk positioning of the CIS, including for example, the liquidity risks associated with the relevant market(s), sector(s), and/or asset class(es) invested in by the CIS;*
- *A commitment in the initial offering documentation to provide to investors on a periodic basis and where appropriate, on an aggregate basis, information regarding the investment portfolios of the CIS ~~that may allow investors to assess the liquidity risk attached to the CIS e.g. holdings of various asset classes/types of securities, detailed holdings of individual securities;~~*
- *The responsible entity will have to prepare contingency plans covering Disclosure in the CIS offering documents of the general approach the CIS will take in dealing with situations where it is under liquidity pressure from a heightened level of net redemption requests. On request, such contingency plans will be shared with the regulator.*

*The disclosure of the liquidity of assets to investors may be transparently done by profiling the projected or actual asset portfolio/asset class(es) which the CIS is currently or expected to invest in. At the time of the launch of the CIS, disclosure of liquidity in the offering documents can be focused on the types of prospective assets targeted by the investment strategy. ~~Thereafter it can be disclosed or reported based on the actual investment strategy and/or assets and instruments held by the CIS.~~ While disclosure regarding liquidity should be balanced against maintaining confidentiality where this is in the interests of investors, sufficient detail in prospectuses should be disclosed to make investors aware of material liquidity risks.*

*Where additional liquidity management tools (see Recommendation 17) are included in the design of a CIS, the types ~~details of how such liquidity management tools would operate, which groups and/or~~*

~~committees with designated responsibility would exercise their activation (and how) and what the activation of such tools would mean for investors should be set out for potential investors in the initial offering documentation. Furthermore, the CIS should explain why it considers these additional liquidity management tools to be appropriate in the relevant circumstances, and how the mechanisms of such tools have been designed to be fair to all investors. The liquidity management process and the liquidity management tools that may be employed by the CIS should be appropriately disclosed in the CIS's offering documents."~~

27. The final part of the second bullet point under "additional disclosure" is a commentary, not guidance and should be deleted.
28. Furthermore, due to market confidentiality reasons, we do not support publicly disclosing approaches the CIS will take in situations where it has to adapt its liquidity management.
29. Excessive market disclosure could have counterproductive results and induce liquidity scenarios that would otherwise not have arisen. Disclosure of details should be only made available to regulators.

#### Question 9

*- Should additional wording be included in Recommendation 12 concerning how responsible entities should proceed when faced with the need to sell assets to the extent that might lead the CIS to vary from its investment strategy?*

30. No, we do not believe Recommendation 12 requires additional wording and we have no suggestions on the proposed text.

#### Question 10

*- Does the proposed additional guidance under Recommendation 13 constitute the appropriate approach for a CIS to assess its redemption obligations and liabilities? If not, what else would you suggest?*

31. Yes, the proposed guidance is appropriate, but we have also proposed a strengthening of the recommendation.
32. We also note further actions IOSCO members could take to assist asset managers in developing more effective stress tests. The ability to study redemption rates among different types of investors would greatly enhance the industry's ability to develop predictive models to understand the potential redemption scenarios to which a fund may be subject. Further intervention by IOSCO members to encourage disclosure by intermediaries of this type of data would be welcome. As such, we recommend that relevant parties provide the following data to fund managers in a consistent format:
  - Types of investors redeeming from and subscribing to funds via omnibus accounts;
  - Size of individual investor holdings to ascertain investor concentration; and
  - Length of time each investor has been invested in the fund.

#### Recommendation 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***

...

*Where possible, the relevant intermediaries responsible should interact with responsible relevant entities to secure compulsory pre-notification about in reasonable time before removal from a “best-buy” list or similar.”*

33. We believe that that intermediaries should be required to inform fund managers in good time of a possible removal of a fund from a best-buy list, in order to anticipate the event which would benefit both investors and the market.
34. This change also addresses the problem that often investment funds do not have full information on all underlying clients in omnibus accounts.

Question 11

*- Are there procedures or practices that responsible entities currently use to implement their stress tests which have been found to be particularly informative to responsible entities and which are not consistent with or included in the approach set out here? If so, please provide examples.*

35. We believe the approach set out in Recommendation 14 is consistent with current procedures and practices.
36. The success of any liquidity risk stress testing guidance will be based on the ability of fund managers to create a meaningful and relevant stress scenario for appropriate to the nature, scale and complexity of each individual fund, which requires sufficient transparency into omnibus accounts. In some cases, what is theoretically ideal from a regulator’s perspective (e.g. that fund managers have the ability to accurately forecast the number of days it will take to liquidate fund holdings at a given price), may not be in line with practical realities (e.g. the OTC nature of fixed income markets makes it difficult to measure liquidation costs and timing).
37. From a liability perspective, the ability to access detailed information about the transactional activity of individual fund investors is limited for many retail CIS (e.g. UCITS) due to contractual limitations and/or operational constraints. For many of these retail funds, investor transactions are incorporated into omnibus trades provided to fund managers by fund distributors who sell products issued by a number of asset managers. Thus, asset managers with retail funds distributed by third parties do not necessarily have access to transactional history needed to fully study investor redemption behaviours. This means that the analysis of redemption behaviour is still in early stages of development. In order to properly forecast redemptions, asset managers will need access to historical redemption data at the transaction level and by type of investor. Even for existing data, the length of available time series to deeply study investor behaviour is inconsistent, since some funds may be quite old, whereas other funds may be brand new.
38. With these limitations as context, we recommend that guidance for fund liquidity risk stress testing be designed using a principles-based approach, recognising that the quantitative precision of liquidity risk stress test approaches will evolve over time. Importantly, any guidance related to liquidity risk stress testing should explicitly acknowledge that such guidance is not a substitute for the judgement of portfolio and risk managers who are responsible for making decisions that are in the best interest of all fund shareholders. In particular, fund managers should be allowed to exercise their judgment with respect to how to respond to the results of their liquidity risk stress tests.

39. Since liquidity stress testing is still in its early stages, regulators should first aim to set these processes in motion and then carefully observe how they progress across the industry. Only once more knowledge and experience has been gathered in the future should regulators consider the feasibility of mandating specifically defined outcomes or required remediation dependent on these stress test results.
40. While the desire to address a perceived liquidity problem may be great, the lack of complete and consistent data or experience with this type of analysis requires a staged and measured approach. To do otherwise is inadvisable because, at best, such measures would be based on insufficient data. Further, a highly prescriptive approach to stress testing and any actions that need to be taken in response to the results of stress tests could result in highly correlated behaviour among fund managers, which could generate precisely the problems that the regulators are attempting to mitigate.

Question 12

*- Are there procedures or practices that responsible entities have not found to be particularly useful which the proposed approach to liquidity stress testing would encourage and why?*

41. No. EU fund legislation (AIFMD, UCITS Directive) already require managers to manage risks in both normal and stressed market conditions. The proposed IOSCO guidelines is a helpful addition.
42. We note that as additional tools are developed and additional data sets become available to managers, these practices are likely to evolve over time.

Question 13

*- Is the proposed approach to the design and operation of stress testing processes realistic and does it deal with the key issues?*

43. Yes, the proposed approach is realistic and deals with the main issues.
44. As noted above, another important issue in operationalising stress testing is the fact that accurate liquidity risk stress testing with at least some level of predictive capacity is dependent upon access to data that is not available to fund managers in many cases today. As such, any guidance on fund liquidity risk stress testing must start with guidance to fund distributors and/or transfer agents that permits fund manager access to necessary data on redemption behaviour to facilitate the predictive value of stress tests. In particular, redemption rates differ by investor type. For example, tax-incentivised investors tend to have a long-time horizon and are often less likely to rebalance their assets.

Question 14

*- Does the proposed additional guidance under Recommendations 3, 7 and 12 add effectively to the available guidance?*

45. Yes, broadly we believe the proposed additional guidance is helpful, but we have also suggested some improvements to the proposed text.

Question 15

*- Does Recommendation 14 capture the best of current good practices in stress testing?*

46. Broadly, we agree with the recommendation, with one important caveat. The proposed approach recommends taking into account the behaviour of other CIS managed by the same responsible entity. We disagree that this is likely to be a useful course of action in most circumstances.
47. Asset managers operate many different business models and assessing reputational risk on the basis of aggregating potential redemptions across a range of different funds, run by different individual portfolio managers ignores a number of key issues that drive likely investor sentiment. These include:
- the stringent asset protection regime imposed on depositaries of most CIS, e.g. under both the AIFMD and UCITS V Directive, which confirms that the fund's assets do not sit on the balance sheet of the asset manager and cannot be used to meet the liabilities arising from another CIS;
  - the likelihood of different investment objectives and investment styles between individual CIS and their respective portfolio management teams;
  - differences in the liquidity features of the various fund structures; and
  - the potential for very different investor profiles and behaviours between CIS.

#### New Recommendation

##### Question 16

*- Does the recommendation add up to an effective testing procedure which will lead to the smooth triggering of applicable liquidity management tools when appropriate?*

48. Yes, we believe the new recommendation 16 is an effective testing procedure. However, we would also emphasise that the design and implementation of contingency planning should be the primary responsibility of the manager. The market environments in which these contingency plans may need to be implemented vary significantly and a course of action needed for one fund may be inapplicable or inappropriate in another set of circumstances.

##### Question 17

*- Other than those examples listed above, are there any additional scope and/or aspect that you consider necessary and appropriate to be included as part of the contingency plan for an effective implementation of liquidity management tools by CIS/responsible entities?*

49. No, there are no additional aspects necessary to include as part of the contingency plan.

##### Question 18

*- How do existing CIS envision transitioning to Recommendation 17?*

50. Individual firms will be able to respond more appropriately to how they would transition to including new liquidity management tools. However, we have proposed a small change to the proposed guidance under new Recommendation 17 below.
51. More broadly, we want effective and harmonised liquidity management tools across jurisdictions, so that managers have the broadest range of tools to deal with any market events.

Recommendation 17

**The responsible entity should consider the implementation of additional liquidity management tools to the extent allowed by local law and regulation, in order to protect investors from unfair treatment, amongst other things, or prevent the CIS from diverging significantly from its investment strategy**

...

*Several additional liquidity management tools have the effect of slowing down the rate at which requests for redemption are paid and providing flexibility for responsible entities to complete portfolio sales required to meet these requests. Assessment of which additional tools are suitable and effective entails consideration of the specific scenario that has led to stressed market conditions, the degree of visibility the responsible entity has on the time required to liquidate assets and whether use of the tool is permitted by local law and regulation. Where the responsible entity is confident that required asset sales can be completed within a set timeframe, the implementation of extended notice/settlement periods and variable notice periods could be considered. Redemption gates and limits on withdrawals have a similar effect of slowing down the rate of redemptions, while retaining a commitment to meet redemption requests within a certain timeframe. In cases where stressed markets have resulted in illiquidity and valuation concerns in specific portfolio assets (e.g. a specific asset class), side-pockets could be implemented to transfer those assets from the CIS portfolio. Suspension of redemptions is a tool that provides for a delay in paying out redemptions and limits a run on the CIS. ~~Suspension can be particularly useful in cases where the responsible entity requires an extended period to liquidate assets or has limited visibility on the timing of asset sales or is reluctant to accept a significant discount to normal market prices.~~ Redemption gates and limits on withdrawals can also be considered for use in these cases."*

52. We do not believe that it is acceptable to suspend redemptions in case of a "significant discount to normal market prices". Such an extreme tool should be limited to circumstances where there is no more market at all (just a drop in prices is not sufficient to justify suspensions), or when the order to be executed would harm market integrity.

ENDS