

# **Recommendations for Liquidity Risk Management for Collective Investment Schemes**

## **Final Report**



**IOICU-IOSCO**

**The Board  
OF THE  
INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS**

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## Foreword

In 2013, the Board of the International Organization of Securities Commissions ('IOSCO') published a report which contained *Principles of Liquidity Risk Management for Collective Investment Schemes* ('2013 Liquidity Report') against which both the industry and authorities were asked to assess the quality of regulation and industry practices concerning liquidity risk management of collective investment schemes ('CIS').<sup>1</sup>

The 2013 Liquidity Report took into account the lessons learned from the financial crisis of 2007-10 and reflected the approach taken by member jurisdictions having responded to those events. The 2013 Liquidity Report was designed as a practical guide for authorities and industry practitioners and focused, for the most part, on the liquidity risk management of open-ended CIS.<sup>2</sup> They were addressed to the entity / entities responsible for the overall operation of the CIS. It was recognised that implementation may vary from jurisdiction-to-jurisdiction, depending on local conditions and circumstances.

Since then, IOSCO has actively engaged with the Financial Stability Board ('FSB') in their analysis of the potential systemic risks arising in relation to the liquidity risk management of CIS, among other matters. The FSB, on January 12 2017, issued recommendations to address structural vulnerabilities from asset management activities that could potentially present financial stability risks.<sup>3</sup> Eight of its nine recommendations relating to liquidity are addressed to IOSCO.<sup>4</sup> In addition, a number of member jurisdictions have conducted further significant work either on updating their own regulatory framework or guidance with regard to liquidity risk management of CIS.<sup>5</sup>

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<sup>1</sup> IOSCO, *Principles of Liquidity Risk Management for Collective Investment Schemes*, Final Report, Report of the Board of IOSCO, March 2013, available at: <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD405.pdf>

<sup>2</sup> By open-ended CIS, in this document we mean a registered/authorised/public CIS which provides redemption rights to its investors from its assets, based on the net asset value of the CIS, on a regular periodic basis during its lifetime - in many cases on a daily basis, although this can be less frequently.

<sup>3</sup> FSB, Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities ('FSB Policy Recommendations'), January 12, 2017, available at:

<http://www.fsb.org/wp-content/uploads/FSB-Policy-Recommendations-on-Asset-Management-Structural-Vulnerabilities.pdf>.

<sup>4</sup> The seven recommendations relevant to liquidity are Recommendations 2-8 of the FSB Policy Recommendations. Regarding Recommendation 1 of the FSB Policy Recommendations, please see the IOSCO June 2016 Statement on 'Priorities Regarding Data Gaps in the Asset Management Industry', available at: <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD533.pdf>

<sup>5</sup> See for example:

- Financial Conduct Authority, *Liquidity Management for Investment Firms: Good Practice*, Feb 2016, available at: <https://www.fca.org.uk/news/liquidity-management-for-investment-firms-good-practice>
- French AMF, *Guide to the Use of Stress Tests as Part of Risk Management within Asset Management Companies*, Aug 2016, available at: [http://www.amf-france.org/en\\_US/Publications/Guides/Professionnels?docId=workspace%3A%2F%2FSpacesStore%2F8e10f441-056c-4809-9881-36c23a292200](http://www.amf-france.org/en_US/Publications/Guides/Professionnels?docId=workspace%3A%2F%2FSpacesStore%2F8e10f441-056c-4809-9881-36c23a292200)
- French AMF, *Public consultation by the AMF on the terms for implementing gates in UCITS and AIFs*, Dec 2016, available at: [http://www.amf-france.org/en\\_US/Publications/Consultations-%20publiques/Archives.html?docId=workspace%3A%2F%2FSpacesStore%2F49e6bd83-3397-4ae4-bcc7-35975b6e9dcc](http://www.amf-france.org/en_US/Publications/Consultations-%20publiques/Archives.html?docId=workspace%3A%2F%2FSpacesStore%2F49e6bd83-3397-4ae4-bcc7-35975b6e9dcc)
- Hong Kong SFC, *Circular to Management Companies of SFC-authorized Funds on Liquidity Risk Management*, July 2016, available at: <http://www.sfc.hk/edistributionWeb/gateway/EN/circular/doc?refNo=16EC29>

Reducing systemic risk is one of IOSCO's three objectives of securities regulation. It forms part of IOSCO's work to develop, implement and promote adherence to internationally recognised and consistent standards of regulation, oversight and enforcement. Principle Six of the IOSCO Principles and Objectives states that each regulator should "... *have or contribute to a process to monitor, mitigate and manage systemic risk, appropriate to its mandate.*"

This final report follows, and builds on, the publication of *CR04/2017 Consultation on CIS Liquidity Risk Management Recommendations* on 6 July 2017. It constitutes the final step in IOSCO's response to the liquidity risk management recommendations that the FSB has turned to IOSCO to provide further guidance on.

To this end, IOSCO has built further on the overall approach previously set out in the 2013 Liquidity Report, taking into account the feedback received during consultation and the financial stability focus emphasised in the FSB Recommendations, together with investor protection considerations. In this document on *Recommendations for Liquidity Risk Management for Collective Investment Schemes* ('2018 Liquidity Recommendations') IOSCO re-affirms and enhances the guidance set out in the 2013 Liquidity Report.

The consultation closed on 18 September 2017. We received 25 formal responses.

Effective liquidity risk management is important to safeguard the interests and protection of investors, maintain the orderliness and robustness of CIS and markets, and helps reduce systemic risk, all of which supports financial stability. The revisions to the text supplement the approach set out in the 2013 Liquidity Report with additional recommendations and more detailed guidance to uphold these objectives by addressing the particular issues highlighted in the recommendations of the FSB.

IOSCO expects that securities regulators will actively promote the implementation by responsible entities of the 2018 Liquidity Recommendations. However, as noted in the 2013 Liquidity Report, when the recommendations are being implemented, they have to be transposed within the context of the specific legal structures prevailing in each jurisdiction. Hence, the implementation of the recommendations may vary from jurisdiction-to-jurisdiction, depending on local conditions and circumstances. Following the adoption of the recommendations and once a period of time for initial implementation has passed (e.g. 2-3 years), IOSCO intends to assess implementation across the relevant jurisdictions.

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- Ontario Securities Commission, OSC Staff Notice 81-727 Report on Staff's Continuous Disclosure Review of Mutual Fund Practices Relating to Portfolio Liquidity, June 2015, available at: [http://www.osc.gov.on.ca/documents/en/Securities-Category8/ni\\_20150625\\_81-727\\_portfolio-liquidity.pdf](http://www.osc.gov.on.ca/documents/en/Securities-Category8/ni_20150625_81-727_portfolio-liquidity.pdf)
  - Romania ASF, Methodology for the Stress Test on Romanian Open-end and Closed-end Investment Funds, July 2016 (yet to be published)
  - US SEC, Investment Company Liquidity Risk Management Programs, Investment Company Act Release No. 32315, Oct. 2016, available at: <https://www.sec.gov/rules/final/2016/33-10233.pdf>
  - US SEC, Investment Company Reporting Modernization, Investment Company Act Release No. 32314, Oct 2016, available at: <https://www.sec.gov/rules/final/2016/33-10231.pdf>
  - US SEC, Investment Company Swing Pricing, Investment Company Act Release No. 32316, Oct 2016, available at: <https://www.sec.gov/rules/final/2016/33-10234.pdf>

IOSCO simultaneously publishes a final report titled Open-ended Fund Liquidity and Risk Management – Good Practices and Issues for Consideration (‘Good Practices Document’) which provides practical information on measures that may be taken to address liquidity risk management. Topics covered include: ensuring consistency between a fund’s redemption terms and its investment strategy; liquidity risk management tools; and stress testing. When implementing the 2018 Liquidity Recommendations, these good practices provide responsible entities with a useful reference point against which to assess whether their own practices follow a similar approach, or to the extent that they vary, whether they can achieve similar outcomes, and furthermore assist with evolving the most effective approach to the responsible management of liquidity.

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# Chapter 1: Why Supplement the 2013 Liquidity Report?

## 1.1 Analysis of Systemic Risks

While IOSCO affirms the overall appropriateness of the 2013 Liquidity Report, it is also part of the role of IOSCO to continue to identify and respond, as appropriate, to emerging risks. The environment in which CIS operate can be affected by a number of significant factors driving change, such as monetary policy, regulatory change, technological change and changes in market confidence. These factors can impact both market liquidity and the behaviour of investors in stressed market conditions. A number of these factors may be at work in the current period.<sup>6</sup> Nevertheless, evidence of a sustained effect on current market liquidity is not conclusive, as outlined by the IOSCO Committee 2 (C2) examination of liquidity in the secondary corporate bond markets.<sup>7</sup> Market spreads remain healthy and CIS liquidity remains strong. However, even if such factors have not translated into an evident deterioration in market liquidity, they are evidence of the constantly changing market environment for which those responsible for managing CIS must be prepared. Securities regulators should have mechanisms to address, or contribute to addressing, crisis situations consistent with their jurisdictional, legal and regulatory framework, having due regard to the costs and benefits of relevant actions.

It is in that wider context that IOSCO has contributed to the work of the FSB in developing recommendations to address “structural” vulnerabilities from asset management activities. The fourteen recommendations which the FSB has developed seek to address four potential sources of systemic risk:

- i. liquidity mismatch between fund investments and redemption terms and conditions for open-ended fund units;
- ii. leverage within investment funds;
- iii. operational risk and challenges in transferring investment mandates in stressed conditions; and
- iv. securities lending activities of asset managers and funds.

Among these four “structural” vulnerabilities, the FSB has highlighted liquidity mismatch and leverage as key vulnerabilities. The FSB Recommendations for liquidity mismatch focus on open-ended funds (public and private, including exchange-traded funds (ETFs), but excluding money market funds (MMFs)). The 2018 Liquidity Recommendations, like the 2013 Liquidity Report, continue to apply to open-ended CIS as defined in footnote 2.

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<sup>6</sup> IMF, Global Financial Stability Report, Chapter 2, ‘*Market Liquidity – Resilient or Fleeting?*’, Oct 2015, available at: [https://www.imf.org/External/Pubs/FT/GFSR/2015/02/pdf/c2\\_v2.pdf](https://www.imf.org/External/Pubs/FT/GFSR/2015/02/pdf/c2_v2.pdf)

<sup>7</sup> IOSCO C2 did not find substantial evidence showing that liquidity in the secondary corporate bond markets has deteriorated markedly from historic norms for non-crisis periods, available at: <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD537.pdf>

## ***1.2 Responsibilities and Key Challenges for Responsible Entities***

The 2018 Liquidity Recommendations emphasise the importance of ensuring the quality of day-to-day liquidity management where CIS are designed to have frequent dealing arrangements. Many of the decisions which responsible entities should take to manage the liquidity of a CIS appropriately involve the use of tools which are a familiar part of routine liquidity risk management activities. However, some of the tools which CIS should have available, referred to here as ‘additional’ liquidity management tools, are more appropriately used in exceptional circumstances<sup>8</sup> with the characteristics of the CIS, prevailing market conditions and other relevant circumstances determining which specific tools to employ and how they should be used in a given situation. This approach acknowledges that there is no ‘one size fits-all’ solution<sup>9</sup> and responsible entities are expected to exercise their sound professional judgement in the best interest of investors.

The recommendations are designed to support the effective exercise of that professional judgement in both stressed and normal market conditions. The recommendations set out an approach under which responsible entities are expected to monitor and evaluate the underlying portfolios of their CIS in light of stressed market conditions and other relevant circumstances in order to determine whether or not to activate additional liquidity tools and, when activated, the manner (e.g. through a single or a combination of liquidity tool(s)) and timing of implementation. Appropriate management of CIS liquidity by responsible entities will help minimise the potential that CIS could transmit stress to the market. In addition, the recommendations also describe a range of initiatives during both the pre-launch/design phase of the CIS and the on-going day-to-day operation of the CIS in order that responsible entities can appropriately manage liquidity and have contingency plans in place to implement the additional liquidity management tools as needed.

However, IOSCO has also observed three particular challenges for responsible entities which it considers appropriate to highlight, and which are addressed within the additional recommendations and guidance:

*Firstly*, with regard to the pre-launch design process, most open-ended CIS offer regular, if not daily, dealing. When responsible entities consider daily dealing appropriate, it is particularly important that other design features of the CIS should be sufficiently robust to ensure alignment of the daily dealing feature with the liquidity of assets of the CIS.

*Secondly*, even where a prudent liquidity management strategy is in place, it remains important to test or otherwise evaluate that liquidity risk management strategy. Stress testing

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<sup>8</sup> Not all of these additional liquidity management tools are available in all jurisdictions. The FSB, in its final recommendations, has also encouraged authorities to review their frameworks and consider broadening the range of additional liquidity tools available to managers. This exercise is under way in a number of jurisdictions. Where this is a matter for legislators rather than for securities regulators, all relevant authorities should stand ready to advise legislators with regard to the merits and risks of the different additional liquidity management tools that might be allowed.

<sup>9</sup> IOSCO 2018 FR02/2018 ‘*Open-ended Fund Liquidity and Risk Management – Good Practices and Issues for Consideration*’.



recommendations or similar evaluations can be particularly useful to a CIS in evaluating its liquidity risk, its capacity to respond to liquidity risks (particularly in difficult market conditions), as well as validating and supporting a good liquidity risk management strategy.

*Thirdly*, under certain circumstances, CIS may be allowed to limit redemption rights or otherwise manage the consequences of redemptions, if permitted by applicable law and regulation, by the use of various additional liquidity management tools. However, an ability to limit, defer or suspend redemption rights, if permitted by applicable law and regulation, should not be seen as freeing the responsible entities from their duty to endeavour faithfully to meet redemption demand in an orderly fashion. Such additional liquidity management tools may be relied on in liquidity management planning, but only in instances of stressed market conditions where to do otherwise could lead to management of the CIS which is not in the best interest of investors or lead to undermining of the investment strategy. Where there is an expectation that additional liquidity management tools can be proportionate to deal with stressed market conditions, there should also be a strong level of assurance that the CIS can actually implement such options in an orderly, prompt and transparent manner. While the implementation of additional liquidity management tools may potentially pose reputational risk to the responsible entity or the CIS, such risk can be mitigated through effective investor communication and putting in place sound contingency plans. Therefore, IOSCO, in producing additional recommendations and guidance around additional liquidity management tools, is encouraging securities regulators to promote clear decision-making processes and planning for CIS implementation of such tools. Ultimately, IOSCO wishes to remind entities that good communication in liquidity issues with their respective regulators is essential.

### **1.3 Securities Markets Regulator Engagement<sup>10</sup>**

The 2018 Liquidity Recommendations are addressed to the responsible entities who manage liquidity risk in all phases of the lifecycle of a CIS (please see recommendations 3 and 4). The primary responsibility for appropriately designing the features of new CIS, effectively managing liquidity risk and then deciding whether to use liquidity management tools rests with the responsible entity, exercising independent judgment based on the individual circumstances facing a fund (recommendation 17). It is the duty of responsible entities to ensure that securities regulators are kept appropriately informed of their actions and, unless otherwise provided by applicable regulation, they should not rely on approval from securities regulators before making their decisions. However, securities regulators should consider communicating more closely with the relevant responsible entities and issuing guidance where appropriate to ensure investors are protected and for financial stability reasons<sup>11</sup>. Situations may however arise, for example market dislocation or widespread stress events, where the responsible entity is not best placed to make that determination. In such instances, there may be a need for securities regulators to issue some form of guidance tailored to the specific circumstances for example, issuing guidance to specific funds. As a last resort, securities regulators should consider the use

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<sup>10</sup> By Securities Markets Regulator or Securities Regulator, this report means the authorities which are empowered to authorise, supervise and/or enforce against relevant rules and legislation relating to the operation of CIS or their managers in their respective jurisdictions.

<sup>11</sup> FSB recommendation 2.

of exceptional tools, considering the costs and benefits of such action from a financial stability perspective.<sup>12</sup>

Authorisation and supervisory models legitimately vary around the globe, as do relevant markets, and so there is no ‘one size fits all’ approach to implementing appropriate liquidity management regulation and oversight of responsible entities. Securities regulators fulfil a key role throughout the entire life cycle of a CIS. They put in place appropriate regulatory requirements for responsible entities and conduct appropriate oversight of responsible entities’ liquidity risk management processes, in both normal and stressed market conditions, encouraging dialogue with entities about it. This applies not only to the ways responsible entities put the recommendations into operation, but also how they ensure they – as responsible entities – function in a robust and credible manner on an on-going basis (see recommendations 12 and 14). In particular, securities regulators that authorise or license CIS and/or their responsible entities should focus on the recommendations relevant to the pre-launch/design phase of the life of a CIS to the extent consistent with local law, as part of the authorisation process. For example, they should, consistently with their overall approach to the authorisation of CIS, consider the proposed inter-relationship between the asset types, the dealing and notice arrangements and disclosure arrangements included in the design of the CIS.<sup>13</sup>

However, there are a number of useful approaches which securities regulators may consider in conducting appropriate supervision of ongoing compliance by CIS and/or responsible entities to the matters covered by these recommendations. Securities regulators may wish to collect appropriate information to monitor the responsible entities and/or CIS in a manner consistent with their supervisory model.<sup>14</sup> They may also expect that responsible entities should be able to demonstrate, when requested, how they periodically test contingency plans, including whether additional liquidity management tools can be activated and used in a prompt and orderly manner. Where securities regulators have concerns relating to the performance of liquidity assessments by responsible entities, it is for example expected that they would take appropriate supervisory action, so that responsible entities address deficiencies in their processes for liquidity assessments.

As noted above, securities regulators<sup>15</sup> should consider providing appropriate guidance which could include, for example, guidance or assistance to the market as a whole, to individual responsible entities or to sub-sectors of CIS as appropriate on the use of additional liquidity risk management tools and issues to consider in such circumstances. Such guidance may be provided in advance of potential stressed market conditions to help improve contingency planning. In exceptional circumstances such as an unpredictable widespread stress or market dislocation, securities regulators should consider whether to provide specific guidance to selected market participants based on specific facts and concerns taking into account cost and benefits of such action. Most likely this will take the form of enhanced engagement with market

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<sup>12</sup> FSB recommendation 4.

<sup>13</sup> FSB recommendation 3.

<sup>14</sup> In line with the FSB’s January 2017 Policy Recommendations recommendation 1, IOSCO C5 plans to review and report on relevant data collection and reporting by securities regulators.

<sup>15</sup> Consistent with the regulatory and supervisory framework of each jurisdiction.

participants (e.g., daily communication, increased data reporting, firm-specific discussions on possible tools), particularly if faced with increasing systemic risks.<sup>16</sup>

Some securities regulators have powers to intervene with a view to supporting orderly market functioning. They can do so by directing the use of some additional liquidity management tools (usually the suspension of redemptions). In practice, the use of this power has been rarely deemed to be necessary. There can be a risk of moral hazard, namely the incentive to take responsibility which should be on individual responsible entities could be diminished in situations where those responsible entities foresee that the securities regulator is likely to intervene. Notably, where predictability is provided around the exercise of such suspension decisions, this could in fact act as a catalyst to exacerbate stress or its transmission. There may also be potential spill-over effects and other possible unintended consequences that should be carefully considered before exercising any direct intervention power which involves requiring CIS to suspend redemptions.

On the other hand, the availability of these tools can be beneficial. Indeed, deployed appropriately, their use or possible use, can create a sense of constructive ambiguity amongst individual market participants which can help to encourage better market discipline in stressed situations.

Where the use of such powers is under consideration, there should be coordination as appropriate amongst authorities (securities regulators, central banks, macro-prudential authorities and micro-prudential authorities) domestically and / or with fellow competent authorities in other jurisdictions (for example in the event of cross-border considerations).

These activities by securities regulators should support the desired outcomes of investor protection, market integrity and financial stability from the application of these recommendations that all CIS have manageable dealing frequencies, effective liquidity management strategies and robust contingency plans.

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<sup>16</sup> FSB recommendation 8.

## Chapter 2: IOSCO 2018 Liquidity Recommendations

This chapter sets out the final IOSCO 2018 Liquidity Recommendations after careful evaluation of the responses to the July 2017 Consultation Report. These recommendations replace the liquidity risk management framework contained in the 2013 Liquidity Report. To this end, IOSCO has built on that previous framework by re-affirming and enhancing its previous guidance and supplementing it through additional recommendations.

### The CIS Design Process Recommendations

#### *Recommendation 1*

***The responsible entity should draw up an effective liquidity risk management process, compliant with local jurisdictional liquidity requirements***

The liquidity risk management process, and its operation, is the fundamental basis of liquidity control within the CIS. The remainder of this section expands on some of the factors that must be taken into account as part of this process. The liquidity risk management process forms one part of the broader total risk management process. Risk management generally relies on strong and effective governance.

Some jurisdictions have an explicit definition of liquidity and set requirements on the “amount” of liquidity certain types of, or all, CIS must have at all times (for example, by a hard requirement on the percentage of the CIS that must be held in liquid instruments; or in the case of certain money market CIS, indirectly through detailed rules on what type of instrument and the proportions that can be held by the CIS).

When considering creating a new CIS, the responsible entity must be able to (demonstrate that they can) comply with the relevant explicit or principles-based local liquidity requirements that will apply to the CIS.<sup>17</sup>

The liquidity risk management process, while proportionate, needs to be able to be effective in varied market conditions. Where the CIS is likely to be at a greater risk of liquidity problems, the responsible entity should construct (and perform) a more rigorous liquidity risk management process. Examples of CIS in this category include, but are not limited to, those with a high proportion of illiquid assets and/or a narrow investor base.

The responsible entity should fully consider the liquidity of the types of instruments in which the CIS’s assets will be invested, at an appropriate level of granularity,<sup>18</sup> and should seek to ensure that, taking account of the CIS’s portfolio as a whole, these are consistent with the CIS’s ability to comply with its redemption obligations or other liabilities.

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<sup>17</sup> The remainder of the recommendations in this document should be interpreted in that context. For example, in the case where a certain percentage of the CIS’s assets must be kept in certain types of liquid instruments, the responsible entity’s systems should be appropriate to ensure that percentage is adhered to at all times.

<sup>18</sup> Consideration at the level of the asset class may not be sufficiently granular - for example, some equities can be liquid and some illiquid.

A responsible entity does not need to construct a new process for each new CIS if it already operates a CIS with similar characteristics. However, it must ensure the process remains appropriate and relevant and sufficiently bespoke for any other CIS it is used for.

### ***Recommendation 2***

#### ***The responsible entity should set appropriate liquidity thresholds which are proportionate to the redemption obligations and liabilities of the CIS***

The responsible entity should set appropriate internal definitions and thresholds for the CIS's liquidity, which are in line with the principle of fair treatment of investors and the CIS's investment strategy. The thresholds should act as a signal to the responsible entity to carry out more extensive in-depth, quantitative and/or qualitative liquidity analysis as part of the risk management process (with the intention that the responsible entity would then take appropriate remedial steps if the analysis revealed vulnerabilities).

For example, a daily dealing CIS would be expected to have stricter liquidity requirements than a CIS sold on the basis that investors would not be expected to redeem before a set period expired; or a CIS that invested predominantly in real estate but promised frequent redemption rights to its investors might consider it appropriate to hold a relatively large stock of more liquid assets (which could be related to real estate) as well, because of the expected length of time it would take to dispose of physical properties in order to meet redemption requests.

A responsible entity could place stricter internal thresholds on liquidity than its local regulatory requirements.

It should be remembered that investor redemptions are not the only source of liquidity demand on a CIS (for example, margin calls from derivative counterparties).

### ***Recommendation 3***

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

Where there is not a specified local requirement, the responsible entity should ensure that they set a dealing frequency for units in the CIS which is realistic and appropriate for its investment objectives and approach, taking account of its liquidity risk management process, and allowing redemptions to be processed effectively.

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, for example, 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 assurance that redemptions can be met in both normal and reasonably foreseeable (i.e. extreme but plausible) stressed market conditions.

The ability to gain certain tax treatment for a CIS, or to access a wider market for distribution, should not lead responsible entities to set a more frequent dealing frequency for units in the CIS than is appropriate.

#### ***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 to meet their redemption obligations. If those obligations cannot be met in a particular situation, then it must be 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, a 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.<sup>19</sup> 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 to an internal approval process at an appropriate senior management and/or board level within the responsible entity where it can be reviewed and updated on an ongoing basis from both portfolio management and risk management perspectives. Such reviews should consider that the aim is to protect investors, maintain market integrity and thereby, as a consequence, promote financial stability.

#### ***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 risk appetite of the investors a CIS is designed to target and in line with the underlying investment mandate. 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

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<sup>19</sup> In particular, having open-ended structures, especially those offering frequent (e.g. daily) redemptions for CIS investing in illiquid assets such as infrastructure or real estate, would need a justification through such documented assessment. For further details, please see boxes 1 and 3 of the 'Open-ended Fund Liquidity and Risk Management – Good Practices and Issues for Consideration', January 2018 at: <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD589.pdf>

counterparty risk, CIS size, trading, limits on time allowed to correct unintended limit breaches and any other limits which could be imposed.

Depending on local law and regulation, responsible entities may also be required to consider the appropriateness of additional liquidity management tools during the design and authorisation process. This may, for example, be required by rules set out in regulatory frameworks or as part of an authorisations process which may consider the appropriateness of liquidity arrangements.

### ***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, (for example, monitoring levels of subscriptions and redemptions), the responsible entity should consider in the design of the CIS an appropriate range of additional liquidity management tools to help manage redemptions in stressed market conditions (particularly those that could lead to severe market dislocation) or instances of unusually high redemptions, if not already required to in the circumstances outlined above. Such tools should be designed to operate in the best interests of investors within the CIS, taking into account the nature of the assets and its investor base. All such tools are subject to applicable laws and regulations.

Where securities regulators have concerns that appropriate consideration may not have been given to these factors they should, where allowed by local law and regulation, exercise their regulatory powers to seek to ensure all reasonable steps are taken by responsible entities to remedy the situation.

The responsible entity should consider the appropriateness of tools and additional measures for their CIS, taking into account the nature of assets held by the CIS and its investor base.

Tools and additional measures should only be used where fair treatment of investors is not compromised, and where permitted by the law and regulation applicable to the CIS.

Examples of tools which may be permissible in certain jurisdictions would include: exit charges, limited redemption restrictions, gates, dilution levies, in specie transfers,<sup>20</sup> lock-up periods, side letters which limit redemption rights or notice periods. Some of these tools (e.g. notice periods) may be built-in to the CIS’s dealing policy, but others may be contingent (e.g. a limit to redemptions met the same day only if redemption requests exceed a certain percentage of the NAV).

Additional measures include side pockets<sup>21</sup> or suspensions. CIS’s should not be managed in such a way that the investment strategy relies on the availability of these measures, should liquidity problems be experienced.

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<sup>20</sup> Retail investors should generally not be required to accept in specie transfers when they wish to redeem part or all of their investments. As a good practice, the responsible entity should only offer investors redemptions in specie where the institutional investor has consented to this arrangement. See “*IOSCO Good Practices on the Termination of Collective Investment Funds Final Report*” Nov. 2017, available at: <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD588.pdf>

<sup>21</sup> In some jurisdictions, side pockets may be considered to be ‘normal tools’ rather than ‘additional measures’ for certain types of CIS. Their creation and use in this manner is generally not suitable for CIS offered to retail investors because illiquid or hard to value assets are not normally suitable for retail investors.

### ***Recommendation 5***

#### ***The responsible entity should consider liquidity aspects related to its proposed distribution channels***

The responsible entity should consider how the planned marketing and distribution of the CIS are likely to affect its liquidity. This should also include consideration of market conditions when forecasting their expectations for the volume, type and distribution of investors, as well as the effectiveness of individual distribution channels.

In some jurisdictions, it is common for investors to hold their investments through aggregated nominee accounts, making it more difficult for the responsible entity to be fully aware of the make-up of the underlying investor base (for example, a holding of one million units in an aggregated account could represent a small number of investors each with large individual holdings, or many more investors each with a smaller number of units). In this situation a responsible entity should take all reasonable steps to obtain investor concentration information from nominees to assist its liquidity management (for example, via contractual arrangements).

### ***Recommendation 6***

#### ***The responsible entity should ensure that it will have access to, or can effectively estimate, relevant information for liquidity management***

The responsible entity should consider its information needs in order to effectively manage liquidity risk in the CIS, and whether it will be able to access that information during the life of the CIS. For example, where the CIS plans to invest in other CIS the responsible entity should be satisfied that it can obtain information about the underlying CISs' approaches to liquidity management and any other pertinent factors such as potential redemption restrictions used by the underlying CISs.

### ***Recommendation 7***

#### ***The responsible entity should ensure that liquidity risk and its liquidity risk management process are effectively disclosed to investors and prospective investors***

As part of the disclosures in a CIS's offering documents<sup>22</sup> about the risks involved in investing in the CIS, there should be a proportionate and appropriate explanation of liquidity risk. This should include an explanation of why and in what circumstances it might crystallise; its significance and potential impact on the CIS and its unit-holders, and a summary of the process by which the responsible entity aims to mitigate the risk.

For example, disclosure of what actions the responsible entity would take in the event of a liquidity problem would be useful information. The explanation should set out clearly how the investor could be affected. In some jurisdictions large unit-holder concentration risk may have to be disclosed.

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<sup>22</sup> The term 'offering documents' here refers to documents that are freely available to investors.



Explanation of any tools or additional measures that could affect redemption rights (see Recommendation 17) should be included in the CIS's offering documents. The explanation should include what the tool or measure is, what effect its use will have on CIS liquidity/investor redemption rights and examples of when the tool or measure might be applied (if it is of a contingent nature). A responsible entity must take care to ensure that these descriptions are clear and comprehensible to investors.

The responsible entity must not consider disclosure of liquidity risk, and information about its liquidity risk management process, to be a substitute for the actual operation of an effective policy.

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.

Basic day-to-day liquidity information (for example, the dealing frequency of the CIS and how to buy/sell units) should be disclosed to investors.

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<sup>23</sup> to assess whether liquidity will vary significantly across the financial cycle.

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

- 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;
- 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.

The disclosure of the liquidity of assets to investors may be transparently done by profiling the actual or projected 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 the confidentiality of market strategies where this is in the

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<sup>23</sup> For example, where a particular asset has only come into existence in recent times, and therefore does not provide a sufficient period of historical evidence. A further example includes where an asset is primarily traded off market, and thus does not provide sufficient historical evidence of performance.

interests of investors, sufficient detail should be disclosed to make investors aware of material liquidity risks. Disclosures should be proportionate to their risks.

Where additional liquidity management tools (see Recommendation 17) are included in the design of a CIS, the details of how such liquidity management tools would operate and what the activation of such tools would mean for investors should be readily accessible and set out clearly and appropriately for potential investors.

## **Day-to-day Liquidity Management Recommendations**

### ***Recommendation 8***

#### ***The responsible entity's liquidity risk management process must be supported by strong and effective governance***

Governance is of paramount importance for an effective liquidity risk management process, as even the most sophisticated liquidity modelling and perfectly predicted cash flows can be made redundant by the lack of effective oversight or controls to deal with the information produced.

While governance structures for CIS differ across jurisdictions and, to an extent, with the size of the responsible entity, appropriate escalation procedures should be in place if problems are envisaged or identified.

Governance arrangements should also ensure that risks to the CIS are considered and managed as a whole (for example, as noted earlier, the inter-relationship between valuation and liquidity).

Again, related to the particular governance structure and size of the responsible entity, there should be an appropriate degree of independent oversight involved in reviews of the liquidity risk management process.<sup>24</sup>

### ***Recommendation 9***

#### ***The responsible entity should effectively perform and maintain its liquidity risk management process***

After a liquidity risk-management process is established pre-launch, it must be effectively performed and maintained during the life of the CIS. The remainder of the recommendations in this section set out some of the relevant considerations relating to such performance and maintenance.

In performing its liquidity risk management process, the responsible entity should take account of the investment strategy, liquidity profile and redemption policy of the CIS. The liquidity risk management process must also take account of obligations of the CIS other than investor redemptions (for example, delivery and payment obligations such as margin calls, obligations to counterparties and other creditors).

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<sup>24</sup> This does not mean the responsible entity necessarily has to involve an external party in the review.

The liquidity risk management process could be performed as part of the wider risk-management arrangements adopted by the responsible entity, involving resource from its risk management and/or compliance functions (where relevant). Risk management and measurement arrangements that are more adaptive (rather than static) and systems that can rapidly alter underlying assumptions to reflect current circumstances are likely to be at the forefront of good liquidity risk management, as are those which utilise a wide range of information and different perspectives and those which incorporate varied scenario analysis in their performance.

Regular periodic reviews of the effectiveness of the liquidity risk management process should be undertaken by the responsible entity and the process should be updated as appropriate. An additional review and possible updates may also be necessitated by the occurrence of certain events. For example, if the CIS is to invest in a new type of asset or if the investor profile has changed materially (from that anticipated) – for example, if a CIS originally expected to have a large number of retail investors but in fact only attracts a small number of institutional investors each owning a significant share of the CIS – the policy should be reviewed and updated, if deemed appropriate.

#### ***Recommendation 10***

##### ***The responsible entity should regularly assess the liquidity of the assets held in the portfolio***

The liquidity risk management process should enable the responsible entity to regularly measure, monitor and manage the CIS's liquidity. The responsible entity should take into account the interconnection of liquidity risk with other risk factors such as market risk or reputational risk.<sup>25</sup>

The responsible entity should ensure compliance with defined liquidity limits and the CIS's redemption policy, whether these are set by national regulation, set out in the liquidity risk management process, detailed in the CIS's documentation or other internal thresholds.

The liquidity assessment of the CIS's assets should consider obligations to creditors, counterparties and other third parties. The time to liquidate assets and the price at which liquidation could be effected should form part of the assessment of asset liquidity, as should financial settlement lags and the dependence of these on other market risks and factors.

#### ***Recommendation 11***

##### ***The responsible entity should integrate liquidity management in investment decisions***

The responsible entity should consider the liquidity of the types of instruments it intends to purchase or to which the CIS could be exposed,<sup>26</sup> as well as liquidity effects of the investment

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<sup>25</sup> It is accepted that some risk factors are difficult or impossible to specify quantitatively.

<sup>26</sup> For some derivatives the settlement asset could be less liquid than the derivative, so this should also be considered.

techniques/strategies it uses, before transacting;<sup>27</sup> and the impact that the transaction or techniques/strategies will have on the overall liquidity of the CIS. Responsible entities should only carry out transactions if the investment or technique/strategy employed does not compromise the ability of the CIS to comply with its redemption obligations or other liabilities.

The assessment of liquidity risk includes the consideration of the type of asset and where applicable trading information (for example, volumes, transaction sizes and number of trades, issue size) as well as an analysis, for each type of asset, of the number of days it would take the responsible entity to sell the asset without materially moving the market prices.

For OTC securities other information may be more meaningful in delivering comparable analysis, such as the quantity and quality of secondary market activity, buy/sell spreads and the sensitivities of the price and spreads.

Liquidity risk management must also consider collateral arrangements (for example, to take account of the risk of deterioration in the quality of collateral received from a counterparty in a derivative transaction, if it were to become illiquid). The liquidity “quality” of securities accepted as collateral should be evaluated on an ongoing basis, in light of collateral arrangements actually in place (for example, segregation of collateral accounts, unavailability of collateral for investment purposes, haircut thresholds and so on). With respect to derivative transactions, the responsible entity should ensure that the quantity of liquid assets is sufficient to meet settlement of margin calls.

The responsible entity should take exceptional care if utilising tools such as temporary borrowing to manage liquidity. Not only will the CIS incur a financial cost for this, but if the temporary borrowing does not solve the problem then the CIS may need to suspend or wind-up and it will at this point be leveraged, potentially with exacerbated problems.

Investors in the CIS that benefit from the borrowing (by being able to redeem) may not be the ones paying the costs of it (remaining unit-holders). However, there may be some cases where inflows can be predicted with some certainty (e.g. if there are substantial regular monthly contributions into the CIS), which mitigate the risks involved with temporary borrowing.

Where a CIS is winding-up, the responsible entity should consider liquidity issues, along with any legal requirements or relevant conditions set out in the CIS’s constituting documents, and balance the early return of proceeds to investors with the need to secure a fair price for the CIS’s assets.

### ***Recommendation 12***

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

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<sup>27</sup> Some investment strategies would preclude detailed analysis before every individual transaction, but application of the liquidity risk management process should provide reasonable assurance that the investment decisions are consistent with the CIS’s overall liquidity profile.

The liquidity risk management process should aim to assist the responsible entity in identifying liquidity pressures before they crystallise, thus enabling it to take appropriate action respecting the principle of fair treatment of investors.

During stressed market conditions, the responsible entity should seek to ensure that the interests of investors are safeguarded and CIS investors are being treated fairly<sup>28</sup> As such, the responsible entity should seek to maintain the investment strategy and attempt to maintain alignment between the funds' investment strategy and its liquidity profile taking into account investors' best interests, including ensuring that remaining investors are not left with a disproportionate share of potentially illiquid assets. One such step could involve the monitoring and management of large redemptions by investors which have the potential to reduce the normal liquidity profile to the extent reasonably practicable.

Retail investors, in particular, will have a general expectation that, in normal circumstances, the CIS will be able to meet redemption requests on the standard terms set out in its offering documents. While the use of additional measures may enable a liquidity issue to be "managed", by restricting investor redemption rights, it is preferable to avoid this if possible. Where a responsible entity has a choice as to whether to apply an additional measure – or a tool - that could affect redemption rights at all, or which of several tools or measures to apply, it must make this decision in the best interests of unit-holders (see Recommendation 17).

Responsible entities should make best efforts to manage future cash flows so as to assist with liquidity management (for example, it may be possible to negotiate a pre-notice period with brokers before changes in margin call formulas become effective, or to negotiate longer periods for repo agreements).

### ***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***

In performing the liquidity risk management process, the responsible entity should consider quantitative and qualitative factors to seek to ensure that in all but exceptional circumstances the CIS can meet its liabilities as they fall due.

Key information should be taken into account which, where known or available or subject to sensible estimate, could improve the capability to manage liquidity risk. Consistent and verifiable statistical methods can be used to generate data and scenarios where appropriate – scenarios can relate to the behaviour of investors and/or the CIS assets.<sup>29</sup>

One of the key challenges in liquidity management is taking appropriate account of the uncertainty in future investor behaviour both in normal market conditions and, in particular, in stressed markets. The more that a responsible entity knows about its investor base, the better able it will be to plan for and manage future liquidity needs. While

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<sup>28</sup> Of relevance is the 'IOSCO Principles for the Valuation of Collective Investment Schemes', May 2013, available at: <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD413.pdf>

<sup>29</sup> For example, the responsible entity may consider whether publicity about the relatively poor performance of a CIS compared to its peer group might lead to an increase in redemption requests and/or a decrease in new subscriptions.

acknowledging that there are operational hurdles<sup>30</sup> that impede responsible entities from accessing information, such entities should make reasonable efforts to understand their investor base. This involves at least considering the marketing and distribution channels of the CIS, and analysing the historical redemption patterns of different types of investors.

As large and unexpected redemptions are a key source of liquidity risk, in combination with other data, for example historical fund flows, this investor information would allow estimates of the pattern(s) of subscriptions and redemptions and identification of realistic stress scenarios when performing the liquidity assessment by the responsible entity, such as a sudden withdrawal by investors (especially institutional investors) holding a significant portion of the funds to meet their own liquidity requirements, or a pattern of withdrawal by a category/type of investors to be identified.

This investor base knowledge could include investor profiles of the various types of investors which may allow the responsible entity to understand why investors are investing in the CIS, their risk appetite and in what circumstances they may wish to redeem. The responsible entity should, where possible, conduct assessments of the characteristics of the investor base in a CIS, analyse the potential impact that these characteristics have on the level of redemptions under different scenarios and take this into account in liquidity management for the CIS.

Data on liabilities such as collateral needs and potential margin calls, should be assessed alongside potential redemption demands.

Where possible, responsible entities should interact with relevant intermediaries to secure pre-notification about removal from a “best-buy” list or similar.

While ensuring the fair treatment of all investors, and no preferential disclosure to select investors,<sup>31</sup> a responsible entity could keep up-to-date with investors who have a large unit-holding in the CIS regarding whether they intend to make significant redemptions. However, this should be done in a way that avoids any conflicts of interest between the responsible entity and such investors - that cannot be properly managed - from arising.

#### ***Recommendation 14***

***The responsible entity should conduct ongoing liquidity assessments in different scenarios, which could include fund level stress testing, in line with regulatory guidance.***

Stress testing can assess how the liquidity profile of, or redemption levels of, a CIS can change when faced with various stressed events and market situations. It is an important component of a responsible entity’s liquidity risk management process. Stress testing should support and strengthen the ability of the responsible entities in managing liquidity risk appropriately in the best interests of investors. Specifically, stress testing can be used by responsible entities to assess the liquidity characteristics of the CIS’s assets relative to the CIS’s anticipated redemption flows under stressed market conditions and to tailor the CIS’s asset composition, liquidity risk management, and contingency planning accordingly. Stress

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<sup>30</sup> Examples of operational hurdles include third party distribution channels (e.g. use of platforms) and the use of nominee structures.

<sup>31</sup> Certain jurisdictions may permit investment funds to enter into different contractual arrangements with different investors.

testing can enable responsible entities to pre-empt and respond promptly to the threat of a liquidity or redemption shock.

Given the diversity of the CIS universe, stress testing arrangements, as further set out below, should be appropriate for the size, investment strategy, underlying assets and investor profile of the CIS, taking into account other relevant market and regulatory factors.<sup>32</sup> For instance, fund level stress tests may not be required where this would be disproportionate taking into account the size, investment strategy, nature of the underlying assets and investor profile of the CIS.

Stress testing should be supported by strong and effective governance. In particular, the performance and oversight of stress testing should be sufficiently independent from the portfolio management function. Responsible entities should maintain appropriate documentation of stress testing and should be able to provide the relevant information to authorities upon request.

Appropriate stress testing should be carried out based on normal and stressed scenarios (for example, atypical redemption requests). Scenarios should include backward-looking historical scenarios and forward looking hypothetical scenarios, and could be based on parameters calculated using statistical techniques or concrete stress events where appropriate to do so.

Stress testing should be based on reliable and up-to-date information. Stress testing scenarios should be appropriate to the CIS. For example, the responsible entity could analyse the number of days that it would take to sell assets and meet liabilities in the stressed scenarios simulated, taking into account where practical and appropriate the expected behaviour of other market participants (e.g. the behaviour of other CIS managed by the same responsible entity if the circumstances are appropriate to do so) in the same conditions, any known inter-fund relationships such as inter-fund lending arrangements, and any actions the responsible entity would take (e.g. imposition of contingent liquidity management tools). In respect of collateral, stress testing could be used to demonstrate that the quantity of liquid assets is sufficient to meet settlement of margin calls on derivatives positions.

Responsible entities could also conduct stress testing related to other market risks and factors. For example, it may be appropriate to assess the impact of a credit rating downgrade of a security held by the CIS as one factor, as such a downgrade can affect the security's liquidity and that of the CIS. Reputational risk from a problem with another aspect of the responsible entity's business, or problems experienced in a similar CIS run by another entity, could also cause unexpected redemption requests.

It is also useful to conduct stress tests which start from the assumption that the responsible entity has been obliged to implement additional liquidity management tools, which then identifies situations where this might occur, and which works through the consequence of operating in those situations. This approach has the potential to improve the understanding of the circumstances in which the CIS may need to resort to additional measures, but it may not be appropriate for all CIS.

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<sup>32</sup> For example, stress testing would be more important and relevant to CIS with less liquid underlying assets and open-ended CIS with daily dealing arrangements.

Feedback from any real situations experienced (“back-testing”) should be used to improve the quality of output from future stress testing.

Stress testing results have the potential to contribute, as appropriate, into all stages of the CIS’s product life cycle, including in the product design stage when determining the dealing and distribution arrangements and asset composition, and in performing investment and liquidity risk management (e.g. in calibrating holdings of liquid assets and other investments, and the use of different liquidity risk management tools and contingency planning) on an ongoing basis. Although it cannot prevail over their best judgement, stress testing can help support responsible entities when they use their best judgement in reasonably foreseeable circumstances.

Stress testing should be carried out at a frequency relevant to the specific CIS, especially in anticipation of reasonably foreseeable stressed market conditions to which the CIS would be sensitive.

### ***Recommendation 15***

***The responsible entity should ensure appropriate records are kept, and relevant disclosures made, relating to the performance of its liquidity risk management process***

As part of performing their liquidity risk management process, responsible entities should be able to demonstrate (to their regulator, for example) that robust liquidity arrangements are in place and that they work effectively.

In order to support the successful implementation of and adherence to the process it should be effectively documented and communicated across the responsible entity’s business. Such documentation should be reviewed as needed, and at least annually in any event. Regular reporting requirements may require risk disclosures, for example in the CIS’s annual report, and in some cases it may be appropriate to detail liquidity risks or issues in this context.

Where there has been a material change to liquidity risk either in level (that is, in the markets relevant to the CIS’s portfolio), the responsible entity’s approach or, for example, if the responsible entity is planning to introduce a new tool or additional measure (see Recommendation 4) that could affect redemption rights or change the CIS’s dealing policy, the responsible entity should inform investors appropriately. In some jurisdictions this may require (prior) approval by the regulator and/or existing investors.

Where an additional measure is applied (e.g., the imposition of a side pocket), existing and potential investors must be informed in an appropriate manner, and kept informed over time (for example, by material on the responsible entity’s website). In some jurisdictions, regulators must also be informed and/or must approve the application of any such measures (in advance).

### ***Contingency Planning Recommendations***

#### ***Recommendation 16***

***The responsible entity should put in place and periodically test contingency plans with an aim to ensure that any applicable liquidity management tools can be used where necessary, and if being activated, can be exercised in a prompt and orderly manner.***



The testing of operational capacity should be such that to the extent possible and on a reasonable basis, the CIS can use all available liquidity management tools, including in stressed market conditions, that will allow for the continued orderly management of the CIS and maintain investor confidence in the management of the CIS.

Having included the appropriate mechanisms in the design of the CIS, the responsible entities should engage in sufficient contingency planning to ensure that any additional liquidity management tool that the CIS can use under applicable law and regulation can be exercised in a prompt and orderly manner. To this end, the responsible entities should plan for such events having regard to whether:

- a) the operational capacity exists to implement and unwind any such tools in a transparent, fair and orderly manner in the best interest of investors;
- b) in those jurisdictions where relevant, the operational capacity continues to exist to exercise such tools at short notice if required by a relevant authority to do so;
- c) the legal basis for the exercise of every tool disclosed in the CIS documentation continues to be assured by the responsible entity to the satisfaction of the relevant decision makers of the responsible entity;
- d) the escalation process for the implementation of any such tools can be conducted in a prompt and orderly manner;
- e) there continues to be procedural clarity as to who is responsible for initiating consideration of and deciding on the exercise any such tools;
- f) there are policies in place as to when the tools will be actively considered and that these policies are documented, clear, accessible to relevant responsible entity decision makers, continue to be aligned with the nature of the CIS and to be understood clearly by relevant decision makers. These policies should take into account applicable law and regulation and be sufficiently detailed to make the governance of and responsibility for the relevant decisions clear;
- g) the capacity exists to keep investors and relevant authorities informed promptly of developments and, if needed in that jurisdiction, all necessary information should be provided at short notice to seek consent from relevant authorities for the use of such tools.

Through such a procedure, responsible entities will establish a reasonable level of internal assurance regarding the policies and procedures in place for triggering and applying such additional liquidity management tools.”

#### ***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.***

Additional liquidity risk management tools, provided that such tools are permitted in the relevant jurisdiction and contained within the CIS constitutional document, can provide valuable assistance in the management of stressed market conditions. There are a number of considerations, related to the specific market conditions and the characteristics of the fund and its investors, to be taken into account when assessing whether to use these tools.

In-kind redemptions and in-specie redemptions facilitate the exit of investors from the CIS without the responsible entity having to liquidate the assets or to deplete cash held by the CIS in order to fulfil their redemptions. A key issue when assessing the use of these tools is the nature of the investors in the CIS, e.g., whether the investors are retail or institutional. The use of in-kind redemptions and in-specie redemptions may not be practical or appropriate for retail investors, especially if the assets are considered relatively illiquid (e.g. real estate, infrastructure).

Anti-dilution levies and swing pricing, where they are available under local law also aim to ensure that investors remaining in the CIS do not incur the costs of redeeming investors. These tools may be considered particularly appropriate where the fund invests in assets where investors may perceive an advantage in redeeming first. By ensuring that costs of transactions required to meet redemption requests are borne by the redeeming investors, these tools provide assurance to remaining investors and remove a potential incentive for investors to redeem. There are a number of factors which the responsible entity should be mindful of in relation to these tools: what the disclosure should be to investors of the conditions which would trigger the use of such tools; the complexities in producing a calculation mechanism; the difficulties in accurately providing for anti-dilution levies to reflect the market impact of the redemption in the redemption price.

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<sup>33</sup> could be implemented to transfer those assets from the CIS portfolio, although they may not always be suitable for use in CIS targeting retail investors. 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.<sup>34</sup> Redemption gates and limits on withdrawals can also be considered for use in these cases.

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<sup>33</sup> See footnote 21.

<sup>34</sup> The IOSCO 2012 Principles on Suspension of Redemptions outline that “The fact of suspension in one CIS, or a small group of CIS, increases concerns about further suspensions and may thus lead to disinvestments/withdrawals in other CIS possibly causing further CIS suspensions.... The suspension may not only directly impact the investor but, depending upon the scale of the CIS, also may have indirect macroeconomic or market-wide implications.”

## **Appendix**

### **Feedback Statement**

#### **IOSCO Board Consultative Report – CIS Liquidity Risk Management Report**

Comments were submitted by the following organisations to the IOSCO Board in respect of the consultative CIS Liquidity Risk Management Report.

1. AFG
2. Allianz Global Investors
3. Amundi
4. Association of the Luxembourg Fund Industry (ALFI)
5. Barnard, Chris (Individual)
6. BlackRock, Inc
7. BVI
8. CFA Institute
9. CNMV Advisory Committee
10. DST Systems
11. EFAMA
12. German Insurance Association
13. HDFC
14. HSBC Global Asset Management
15. ICI Global
16. ICMA
17. Investment Trusts Association, Japan
18. Irish Funds
19. Reliance Nippon Life Asset Management Limited
20. SIFMA
21. State Street Bank and Trust Company
22. The Investment Association
23. US Chamber of Commerce
24. Vanguard

These comments were taken into account in the preparation of the final recommendations regarding CIS Liquidity Risk Management. This feedback statement seeks to summarise the major issues covered by the comments and notes certain changes that have been made in the Final Report.

In general, most of the feedback was supportive of the proposed framework, and the objectives and principles C5 was updating. A number of respondents confirmed the concerns the FSB has had about the growth in less liquid investments found in open-ended funds. There is a need to have a more holistic approach to improve the resilience of the financial markets. Some

comments confirmed the need to have more guidance to improve issues such as disclosure.<sup>35</sup> There was confirmation that investors must know and understand the risks of the products they invest in, including liquidity and the implications of the use of liquidity management tools. One reply, though, stated that disclosure should be limited to facts and only address tools that would be used in practice.<sup>36</sup>

There was also support on the recommendations asking jurisdictions to expand usage of as many liquidity management tools<sup>37</sup> as possible. One reply reminded regulators that the tools “could be highly disruptive” too. Others commented that very few past incidences have “triggered a need” to use the tools.

Finally, there was support for liquidity stress testing. Trade bodies suggested that smaller firms could be challenged to do this to the extent anticipated. They commented that stress-testing would still be “judgement-based”, cautioned against prescribing the use of standardised stress-testing methodologies, encouraging a more principles-based approach. Many respondents were also keen to emphasise that seeking to apply bank-like stress testing models was not appropriate in a funds context. They argued that the objectives and requirements used for bank stress-testing were not applicable to open-ended CIS, and failed to account for the differences in the two business models, noting that these are “funds and not banks.”<sup>38</sup>

There were a number of challenges some members of the industry and their trade bodies made, namely:

### **Further work to establish the materiality of the risks**

A number of trade associations<sup>39</sup> continue to question whether the risk of a liquidity crunch in less liquid securities markets, triggering a redemption dislocation, could impact financial stability. They suggested they had not seen enough evidence that “liquidity risk in one or more open-ended CIS implicated global systemic risk.”<sup>40</sup> They suggested IOSCO needs to carry out further studies of this liquidity risk before implementing the revised principles.

IOSCO has worked alongside FSB to define and refine these issues and released a report in January 2017<sup>41</sup> outlining the concerns, and making recommendations for IOSCO to consider. The document points to a number of academic studies and also references papers from the IMF with regard to this risk. The recommendations that the FSB made were asking for proportionate guidance to the industry on liquidity management. IOSCO had already set out liquidity management principles in 2013. Through the recommendations found in this final report, IOSCO is now providing further enhanced and additional guidance to address the additional ‘residual’ risks identified in conjunction with the FSB. These recommendations reflect the appropriate liquidity management tools that should be considered, along with adjustments to

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<sup>35</sup> CFA Institute letter, p. 3

<sup>36</sup> US Chamber of Commerce letter, p. 8.

<sup>37</sup> The Investment Association letter, p. 25.

<sup>38</sup> HSBC letter at 2, SIFMA letter, p. 3.

<sup>39</sup> SIFMA letter at 3, US Chamber of Commerce letter, p. 2.

<sup>40</sup> US Chamber of Commerce letter, p.2.

<sup>41</sup> “Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities”, FSB, 12 January 2017.

existing design and review principles. Liquidity risk is already considered part of professional portfolio management, and IOSCO is emphasising the stress-testing angles that many firms already consider. IOSCO believes that the work it has conducted is proportionate to the liquidity risk posed by the growing amount of investment found in less liquid securities and that this guidance, when implemented appropriately, and consistently across the sector, should help to mitigate the risk to financial stability posed by a redemption dislocation.

### **Perceived restrictions on portfolio managers**

A number of challenges were made about liquidity buffers and any restrictions that are put on the portfolio managers' abilities to manage all aspects of the portfolio including liquidity risk.

While the revisions IOSCO has made do not require stringent buffers, comments such as "best to keep in the hands of portfolio managers" "not regulators" were included in some of the early comments and one reply had concerns that there might not be sufficient discretion for fund managers left. IOSCO's work has not been designed to undermine the work of portfolio managers, but to strengthen their options when faced with difficult market conditions, and better guide responsible entity's governance and decision-making throughout the lifecycle of a fund.

Some of the replies suggested there was a stronger argument for the use of redemption gates and swing pricing as opposed to higher liquidity buffers. Others also opined that there was a clear trade-off between liquidity and economic efficiency, noting that "perceived benefits to financial stability reduces the ability to intermediate" working capital to business. One respondent suggested that a "1% change in liquidity buffers globally means \$750 billion is eliminated from the lending capacity of the economy,<sup>42</sup> especially at a time when another respondent noted there is "an inability of corporate treasurers...to raise short-term capital."

Many respondents, as a result, suggested that IOSCO conduct a post-implementation review of the effectiveness and impact of the recommendations. As noted, IOSCO expects that authorities will actively promote the implementation by responsible entities of the 2018 Liquidity Recommendations. Following the adoption of the recommendations and once a period of time for initial implementation has passed (e.g. 2-3 years), IOSCO intends to assess implementation across the relevant jurisdictions.

It should be noted that IOSCO believes that the best line of defence against a liquidity mismatch remains with the CIS and the responsible entity. The updated principles have reviewed all liquidity management practices globally and suggested that as many tools as jurisdictions can allow be made available to the responsible entity. It should also be noted that securities regulators expect the exceptional tools to be used sparingly and only as necessary, clearly guided by the best interests of investors. Moreover, they should not avoid using the tools for fear of franchise damage. In times of severe liquidity stress managers should reach out to their regulators to discuss steps such as suspension, or in some jurisdictions seek approval for a suspension.

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<sup>42</sup> HSBC letter, p. 3.

## Comments on ETFs

The consultation paper asked a number of questions about whether the liquidity profile of ETFs differs from that relating to more traditional open-ended funds. Most respondents, from industry to trade bodies, asserted that ETFs are no riskier than other CIS.<sup>43</sup> They also added that ETFs have unique qualities that make them less susceptible to liquidity events than other CIS, such as in-kind redemptions<sup>44</sup> and secondary market trading.<sup>45</sup> The suggestion was that ETFs should not have a separate section with regard to liquidity management.

Even when addressing the counter-party risks associated with the reliance on the authorised participant's (AP) role in liquidity, respondents still asserted that ETFs would continue to trade on an exchange when primary markets might be closed. This has clearly happened previously during public holidays,<sup>46</sup> for example. Failure of the AP, does not appear to be a concern; this is especially true where respondents had contracted with multiple APs.<sup>47</sup>

The respondents mentioned other characteristics of ETFs that they thought might support a better liquidity profile than CIS. These included the transparency of the underlying portfolios and the suggestion that a first-mover advantage and/or a fire sale risk do not apply to ETFs.<sup>48</sup>

European respondents also felt that the UCITS legislation adds both diversification and liquidity risk management requirements to UCITS ETFs,<sup>49</sup> and also allows investors to redeem directly from the ETF when secondary market spreads diverge significantly from the NAV. It was also pointed out that the US SEC has tailored its risk management program requirements for in-kind ETFs.

IOSCO has now asked C5 to consider a wider examination of concerns securities regulators have about the ETF market. One suggestion from the consultation was that a different set of principles might be necessary for this segment of the asset management industry. IOSCO, for the moment, has agreed that the Principles for liquidity management should apply to ETFs and that a special section is not needed.

## Other Concerns

A few other comments were made urging IOSCO not to consider applying prescriptive redemptions rules around asset classes or restricting access to certain asset classes. In this regard, IOSCO has not provided prescriptive guidance on redemption and notice periods.

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<sup>43</sup> E.g. Vanguard, BlackRock, State Street GA, BVI, Irish Funds Association and others.

<sup>44</sup> SIFMA: 'ETFs that redeem primarily in-kind do not pose issues related to on-demand liquidity. [...] Investors' liquidity needs are satisfied through secondary market activity and through the actions of the Authorised Participants.'

<sup>45</sup> HSBC: The AP mechanism and secondary market activity distinguish ETFs from other CIS. BlackRock: Secondary market introduces a further layer of liquidity removed from the fund (i.e. portfolio).

<sup>46</sup> Highlighted by the European Fund and Asset Management Association.

<sup>47</sup> E.g. Amundi Asset

<sup>48</sup> Vanguard: 'if the size of the premium or discount were to exceed the heightened transaction costs of the underlying market, market makers and APs would have an incentive to engage in the creation or redemption of new ETF shares.'

<sup>49</sup> ESMA's 2012 Guidelines and the UCITS Directive already contain significant diversification and liquidity risk management requirements, including illiquid asset performance monitoring and portfolio stress testing, as does MiFID.

Rather the paper reminds firms that they should thoroughly review the redemption periods they assign to their funds and consider the appropriateness of those redemption periods against the liquidity of the underlying securities held in the portfolios. Such decisions should not be based solely of the requirements of distribution chains. Finally, IOSCO reminds firm failure to make such consideration could result in regulators taking remedial steps.

A few respondents also suggested that IOSCO should make it clear there should not be an over-use of liquidity management tools and that IOSCO needed to be mindful of unintended consequences if they were misused.

There were also some concerns about the lack of clarity around the role of regulators when funds face liquidity problems leading to a redemption mismatch. As a result of these comments, section 1.3 has been added to the paper to more clearly explain that role.