European Fund and Asset Management Association

EFAMA's Reply to IOSCO Principles on Liquidity Management in Collective Investment Schemes

EFAMA is the representative association for the European investment management industry. EFAMA represents through its 26 member associations and 59 corporate members approximately EUR 14 trillion in assets under management of which EUR 7.9 trillion was managed by approximately 54,000 funds at end March 2012. Just above 36,000 of these funds were UCITS (Undertakings for Collective Investments in Transferable Securities) funds. For more information about EFAMA, please visit www.efama.org.

Thank you for giving us the opportunity to submit comments on IOSCO Principles on Liquidity Management in Collective Investment Schemes. The present reply first sets out some general comments (see Section I hereafter) before commenting each of the IOSCO Principles proposed (please refer to Section II below).

I. General Comments

EFAMA welcomes as very positive and fully supports the initiatives aimed at enhancing safety and sound management of clients' assets. EFAMA also welcomes the confirmation that any proposed change to national legislation or regulation must be subject to the relevant jurisdiction's or region's process for consulting upon and implementing changes to legislation or regulation.

More generally, EFAMA would also like to highlight that European investment funds managers are already subject to high standards of liquidity risk management. UCITS managers, especially, are required to employ an appropriate liquidity risk management process in order to ensure that the funds they manage are able to meet redemption requests from investors. This liquidity risk management process is part of the permanent risk management function that UCITS management companies must establish which must be functionally and hierarchically independent from other departments within the management company. Managers are required to measure and manage at any time the risks to which the fund is or might be exposed, including the risk of massive and unexpected redemptions. It should therefore be emphasized that risk management in UCITS is already state-of-the art and has been further enhanced by the entry into force of the UCITS IV Directive in July 2011 which has introduced even more detailed provisions on internal control mechanisms for the UCITS management company.

In the AIFMD the Risk Management function, including the management of liquidity risks will be functionally and hierarchically separated from the operating units of the AIFM.

The robust liquidity risk management processes put in place by European investment fund managers certainly explains in large part why the vast majority of European UCITS investment funds went through the global financial crisis in 2008 without major problems.

It is worth mentioning that in exceptional circumstances where – despite the liquidity management process in place - a fund would temporarily be unable to meet the redemption requests from

rue Montoyer 47, B-1000 Bruxelles
☎ +32 2 513 39 69 • Fax +32 2 513 26 43 • e-mail : info@efama.org • www.efama.org • VAT Nr BE 0446.651.445

investors, the fund manager still has the ability to temporarily suspend redemptions in the interest of its unit holders (as foreseen in Article 84 of the UCITS directive) or to use other tools such as 'gates' to manage redemption requests in an orderly manner. This is an important investor protection tool.

Finally, EFAMA notes that the focus of the paper is entirely on the need to ensure liquidity for the purposes of meeting redemptions. Liquidity management is equally important in terms of managing inflows. The size of a fund can, in certain market conditions, prejudice the interests of investors if the manager cannot establish positions in assets or strategies that enable him to produce the outcome expressed in the fund objective. It is also important that regulators provide liquidity management tools, such as the ability to limit the issue of units, in cases where it is in the interests of the fund so to do.

Principle 4 on page 7 could include the ability to limit the issue of units in circumstances where it is in the interests of the fund's investors and Principle 5 on page 7 could refer to the need for firms to apply regular assessment of the level of its marketing activity, for example, in respect of rapidly growing or large funds or funds where asset concentration is a significant consideration, e.g. single country funds and real estate funds.

We also recommend that the final paper encourages regulators to review their rules to ensure that they are as flexible as practicable (in terms of liquidity management tools they make available) to allow for effective liquidity management.

Section II. Comments regarding the proposed IOSCO Principles

Principle 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 the principles in this section expand on some of the factors that must be taken into account as part of this process.
As mentioned in the introduction, 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 principle-based local liquidity requirements that will apply to the CIS.

The remainder of the principles 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 a certain type of liquid instruments, the responsible entity's systems should be appropriate to ensure that percentage is adhered to at all times.

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 and should ensure that these are consistent with the CIS's ability to comply with its redemption obligations or other liabilities.
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 for any other CIS it is used for.

EFAMA also recommends amending the 5th paragraph of this Principle 1 to recognize the existence of the different factors that are outside the control of the operator. The liquidity of the types of instruments in which the CIS invests its assets is not precise enough. Equity is a type of instrument, yet some equities can be illiquid. If one sets up a proper liquidity risk management, one has to take into account the strategy of the CIS, and not general definitions of instruments. Consequently, no responsible entity can "ensure" as expressed in that paragraph. The only possible achievable aim is to "seek to ensure" the required results.

EFAMA would also highlight that it is the portfolio as a whole that must be consistent with the CIS's redemption obligations. For instance, one can, for example, have illiquid investments provided that, as a whole, the CIS is able to meet its obligations.

EFAMA proposes the following amendment to the 5th paragraph of Principle 1:
"The responsible entity should fully consider the liquidity of the types of instruments in which the CIS's assets will be invested and should seek to ensure that these are CIS portfolio as a whole is consistent with the CIS's ability to comply with its redemption obligations or other liabilities."

Principle 2

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

The responsible entity should set appropriate internal definitions and limits for the CIS's liquidity under normal market conditions. / at time of the launch of the CIS, which are in line with the principle of fair treatment of investors and the CIS's investment strategy.

For example, a money market 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 limits 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).

EFAMA believes that Principle 2 should allow a wider range of liquidity risk management approaches including qualitative measures.

EFAMA disagrees with example stated in the second paragraph and the reference to Money Market Funds (in particular because it would contribute to greater confusion between time to maturity of an asset and the measure of its liquidity). A reference to daily dealing funds for retail investors would be much more appropriate.

For some instruments, even the ones that may seem liquid, the secondary market may be a source of information (when available) that may provide an estimate about liquidity. However, before launch of a CIS, such information may not be available, or it may not be advisable to seek such information before launch as this will indicate to the market what holdings the CIS is going to buy and therefore potentially negatively impacts prices.

Imposing a minimum liquidity requirement in the industry would permit all CIS to have the same liquidity requirements. This would enable all CIS to base their investments on the same requirements, and would therefore avoid performance of some CIS to be penalized if the internal risk limit is more stringent for some companies than others. But one should keep in mind here that UCITS framework already sets requirements with respect to minimum liquidity requirements (please see below).

Additionally, EFAMA believes that the examples given in paragraph 2 are only appropriate during normal market conditions, but impossible to determine for certain when market conditions are unstable. The redemption obligation and liability of a CIS pre-launch are extremely difficult to define.

This principle would be more useful AFTER the launch when one knows the inflows/outflows with time periods, and can therefore better calculate the obligations and liabilities of the CIS.

EFAMA also recommends that the Principle and accompanying commentary uses the language ‘thresholds’ rather than ‘limits’. The focus of the Principle should be on the need to set thresholds that trigger action. Liquidity management requires the application of both quantitative and qualitative analysis. The commentary should therefore focus on the expectation that the responsible entity should have a qualitative review process which is triggered when a threshold is met.
Consequently, EFAMA believes that across Principles, the word “limit” should be replaced by "criteria or thresholds", which is not as binding and stringent and allows for a more qualitative assessment.
In addition, “Limits” or “Thresholds” can be construed as implying a breach if exceeded. That has a negative connotation and presumes the need for correction. The emphasis should be on the need to set in train a review process once internal thresholds are met. As a practical example, the review may identify that a significant and certain inflow is imminent such that the reaching of the threshold does not cause an issue.

Finally and as general remark, it can be added that all UCITS managers are required to employ an appropriate liquidity risk management process in order to ensure that the funds they manage are able to meet redemption requests from investors. This liquidity risk management process is part of the permanent risk management function that UCITS management companies must establish which must be functionally and hierarchically independent from other departments within the management company. Managers are required to measure and manage the risks to which the fund is or might be exposed, including the risk of massive and unexpected redemptions. Imposing minimum liquidity requirements would imply some challenges/drawbacks:

- Minimum liquidity requirements would force CIS to shorten their investments or buy a higher percentage of government securities at the expense of banking or corporate commercial papers.
- Regulators would have to address how to define “liquid” assets.
- It should also be clear that the regulatory requirements would only apply when a security is purchased. A temporary difference should be acceptable if the liquidity position is used to meet a redemption that causes the fund liquid assets to fall below the liquidity ratios. There should not be any (global) liquidity restrictions for liquid or illiquid assets.
- The usefulness of minimum liquidity requirements should not be over-estimated as the liquidity of short-term debt securities may change strongly over short periods of time. From this perspective, imposing strong requirements regarding liquidity risk management is be a superior tool to manage liquidity.

Principle 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 (for example, daily dealing is unlikely to be appropriate for a CIS investing predominantly in underlying assets that are illiquid).
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.

EFAMA is of the opinion that there will be circumstances in which daily dealing, in a CIS investing predominantly in underlying assets that are illiquid, could be inappropriate, e.g. where a CIS has in place a notice period for redemption requests and/or has limited redemption arrangements. The suitable dealing frequency should be authorised then to be changed after the CIS has been launched. Cash allowed in the CIS should also be taken into consideration.

In our view, this might require a dedicated and standardized process for monitoring the fund's liquidity. By means of standardized processes, the risk controlling function needs liquidity key indicators, some of which being already publically available (e.g. Bloomberg feeds or other data providers).

We would therefore recommend that the example given in brackets at the end of 1st paragraph under Principle 3 is expanded as follows:
"(for example, daily dealing is unlikely to be appropriate for a CIS investing predominantly in underlying assets that are illiquid and the responsible entity has not put in place liquidity management tools to enable it to meet its obligation to deal on a daily basis)".

Principle 4

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

Certain tools can be used as part of a CIS's "normal market conditions" operations, provided there is full disclosure (see principle 7 below) - but the availability of such tools does not replace the need for an effective liquidity risk management process. Where such tools are in fact used to make up for a failure in liquidity risk management, the responsible entity should be aware they may face supervisory action.

The responsible entity should consider the appropriateness of tools and exceptional measures for their CIS, taking into account the nature of assets held by the CIS and its investor base. Tools and exceptional measures should only be used where fair treatment of investors is not compromised, and where permitted by the laws applicable to the CIS.

Examples of tools which may be permissible in certain jurisdictions would include: exit charges, limited redemption restrictions, (investor level) gates, dilution levies, *in specie* transfers, 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).

Retail investors should generally not be required to accept *in specie* transfers when they wish to redeem part or all of their investments.
In some jurisdictions, side pockets may be considered to be 'tools' rather than 'exceptional measures' for certain types of CIS.

The term *offering documents* here refers to documents that are freely available to investors.
Exceptional measures include side pockets 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.

EFAMA strongly believes that the first paragraph of the Principle 4 should be deleted. Indeed, we believe that the words "but the availability of such tools does not replace the need for an effective liquidity management process" are misleading.

Liquidity management tools are an integral part of a company's management and should not be seen as an "emergency" solution.

EFAMA proposes therefore to create a distinction between normal liquidity management tools and measures used in truly exceptional circumstances (e.g suspension).

Should this Principal 4 be maintained, EFAMA recommends clarifying the introductory sentence and the first paragraph of Principle 4. Some concepts are undefined and therefore introducing uncertainties like "normal" as opposed to "abnormal" market conditions". As mentioned in our opening comments, the UCITS framework already provides the ultimate investor protection mechanism for exceptional circumstances. The fact that this occurs rarely is testament to the sound liquidity management processes.

Principle 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 fully understand the size and breakdown of individual unit-holders. In this situation a responsible entity should take all reasonable steps to obtain investor concentration information from nominees to assist its liquidity management.

As general comments on Principle 5, EFAMA believes that this principle raises 3 problems:

1) the information about the volume, type and distribution to investors should not influence the investment decision or strategy of the fund manager who must manage the fund in accordance with its investment objectives and policy; and
2) this information is not easily available or relevant; and
3) the Principle 5 sets up a means to collect information that is necessary to understand the environment at the launch of the CIS. However, this information will only be available in specific cases, for instance when an institutional fund is already a client of the firm that intends to subscribe to the new CIS.

Therefore, taking into account information about distribution channels, investors, volume should only be considered when the information is relevant and available.

EFAMA is of the opinion that, in practice, these aspects are already an essential part of the business strategy of a CIS or the new product process. CIS should consider liquidity aspects related to its distribution channels, where relevant and available.

If obtained, the information provided by distribution channels is sometimes limited. For instance, for retail investors, there are only 1 or 2 aspects that we can take into account to define their risk management (i.e. retails investors will typically sell in bad economic conditions).

The mention of "effectiveness of individual distribution channel" is also vague; EFAMA wonders what conclusion can be drawn given the vagueness of this wording..

It is helpful that the commentary recognises the practical difficulties that arise in intermediated markets, with some intermediaries that are regulated and others not. Where regulated, we recommend that regulators consider requiring that such intermediaries to meet the liquidity management information needs of a CIS's responsible entity.

Therefore, it should be clarified that, considering distribution channels existing regulations, this might not be the most crucial area from a liquidity risk perspective.

Principle 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 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.

EFAMA believes that the responsible entity should consider its information needs in order to effectively manage, to the best of its knowledge, 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.

The wording of Principle 6 should recognise that it is not possible to ensure such an outcome. This point is recognised in the commentary accompanying Principle 5. It is impossible to ensure access to relevant information. There will also be circumstances where it is not possible to ensure effective estimation of liquidity - as Chapter 1 recognises liquidity risk management in CIS is a complex area and poor liquidity may arise from many different sources, some of which are outside the control of the entity operating the CIS (pg 1).

We therefore recommend that the Principle be amended as follows:-

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

The accompanying commentary to Principle 6 should also reflect the abovementioned constraints.

Principle 7

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

It is expected that a CIS's offering documents would include an explanation of liquidity risk, why and in what circumstances it might arise and its significance and potential impact on the CIS and its unit-holders, as well as an appropriate 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 or the breach of internally set limits would be useful information. However, lengthy legal disclaimers or overly granular disclosure which would be confusing to investors should be avoided. In some jurisdictions large unit-holder concentration risk may have to be disclosed.

Explanation of any tools or exceptional measures that could affect redemption rights (see principle 4 above) should be included in the CIS's disclosure. 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 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.

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

EFAMA would like to highlight that

1) legal disclaimers cannot be avoided when it comes to disclosing liquidity risk and liquidity risk management process, especially in exceptional market conditions. It is unfair to request CIS not to have legal disclaimers on this aspect, and avoiding it can seriously open the door to unfair and potentially fatal litigation.
2) This principle and commentary sets out too detailed a level of information for investors. The quantity of info required will undoubtedly confuse them. One may communicate some information about the liquidity risk, but not the information about the in-house models used to evaluate the risk.

Explaining the risk management process to investors may be very confusing. We think that some general information about risk (as presented e.g. in the KIID for UCITS) is a sufficient and relevant tool to inform investors.

Explaining the risk management process to investors may be very confusing and hard to understand. We do not think it is an adequate way to present to investors the risk involved.

EFAMA believes that this Principle 7 should also make clear that the disclosure should also be done via a document that is freely available to investors. Without this clarification in the Principle, it could be read as requiring the supply of the information as a pre-contractual requirement.

Consequently, EFAMA proposes the below:
We recommend the principle be amended as follows:-

"The responsible entity should ensure that the CIS's offering documents provide adequate information on liquidity risk and their liquidity risk management."

We also concerned about the level of detail specified in the accompanying commentary. The information should be sufficient for investors to understand the liquidity management tools that the operator may employ and the potential impact upon redemption rights. The provision of too much information can create and amplify liquidity risk.

Disclosure requirements must be understood in such a manner that only a summary of the general implemented liquidity process for all funds has to be disclosed. Special liquidity information such as liquidity ratios or internal liquidity limits of the fund should be for internal purposes only.

Chapter 4: Day-to-day Liquidity Risk Management Principles
Principle 8

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 principles 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, expected margin calls, obligations to counterparties and other creditors).

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 utilize a wide range of information and different perspectives and those which incorporate varied scenario analysis in their performance.

Regular reviews of the effectiveness of the liquidity risk management process should be undertaken by the responsible entity. The process must be updated if, for example, the CIS is to invest in a new type of asset or if the results of distribution of the CIS have resulted in a different investor profile to that anticipated.

We suggest the following amendment to the 2nd paragraph of principle 8:

> "… 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** ~~expected~~ margin calls, obligations to counterparties and other creditors).

In our view, the wording "expected margin calls" could be misunderstood as an obligation to calculate a margin call in advance (for example, by means of real-time pricing on the basis of current market data). Such real-time pricing would be very costly, time-consuming and almost infeasible. Moreover, we do not see any added value in view of daily calculation of margin calls. Therefore, it should be clarified that general payment obligations (such as margin calls) are relevant criteria for the liquidity risk management process (see also our Proposal to Principle 11).

Principle 9

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 modeling 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).

There should be an appropriate degree of independent oversight involved in reviews of the liquidity risk management process. This does not mean the responsible entity necessarily has to involve an external party in the review. It is accepted that some risk factors are difficult or impossible to specify quantitatively.

For some derivatives the settlement asset could be less liquid than the derivative, so this should also be considered.

EFAMA agrees with the proposed Principle 9 but would suggest amending the fourth paragraph:
There should be an appropriate degree of independent oversight involved in reviews of the liquidity risk management process *if relevant*. This does not mean the responsible entity necessarily has to involve an external party in the review. It is accepted that some risk factors are difficult or impossible to specify quantitatively.

Principle 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 continuously 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.
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 limits.
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.

As the Principle refers to the need to regularly assess liquidity, for consistency, EFAMA proposes to amend the proposed Principle 10, stating that "regularly" should replace the word "continuously" in the first line of this paragraph. The change also recognises the principle of proportionality. Frequency of the monitoring and the review of compliance of the rules can be tailored to the characteristics of the fund concerned.

To be aligned with the proposal made in Principle 2, EFAMA also suggests that "Criteria" or "Thresholds" should replace the word "limits" for the reasons given in comments relating to Principle 2

Principle 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 exposed14 before transacting, and the impact that the transaction will have on the overall liquidity of the CIS during the lifetime of the investment. Responsible entities should only invest in assets if the investment 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. The assessment of liquidity risk by asset type should also consider any fiscal constraints (for example, where asset sales would trigger a large tax liability which in effect reduces their liquidity).

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).

The responsible entity should take exceptional care if utilizing 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.

EFAMA considers that it is not possible to know with certainty what impact future events might have on a holding. The requirement mentioned in the 1st paragraph under Principle 11 should be for investment managers to keep such investments under review.

Consequently EFAMA recommends the removal of the wording “and the impact the transaction will have on the liquidity of the CIS during the life of the lifetime of the investment” from the 1st paragraph under Principle 11.

We strongly disagree with the proposal that the assessment of liquidity risk by asset type should also consider any fiscal constraints. Therefore, the last sentences of the 3rd paragraph of principle 8 should be deleted:

> ~~The assessment of liquidity risk by asset type should also consider any fiscal constraints (for example, where assets sales would trigger a large tax liability which in effect reduces their liquidity.~~

In practice, the requirement that the assessment should consider “any fiscal constraints” cannot be fulfilled. Fiscal requirements constantly change and differ across the world, even retrospectively (for example, in India where the requirements to pay withholding tax are changed retrospectively, backdated from 2012 to 1962). Therefore, it is very difficult verifying all fiscal requirements on a daily or regular basis. In our view, a general reference to the fact that the liquidity risk management process must also take account of delivery and payment obligations (see above our proposal to Principle 8) should be adequate and sufficient. Otherwise, IOSCO should give examples of assets or types of assets which are relevant for considering any fiscal constraints.

With regard to the 4th paragraph under Principle 1, we query the inclusion of this paragraph.
This consultation paper deals with the requirement to manage the liquidity of the fund’s investment portfolio so that the CIS can meet its investor dealing obligations.

This principle requires that the liquidity “quality” of securities accepted as collateral should be evaluated on an ongoing basis, in light of collateral arrangements actually in place. Management of risks relating to collateral (including the assessment of the liquidity thereof) is part of the collateral management process and not of the liquidity risk management process, so there is no actual need to require liquidity risk management for collateral in this document.

Additionally, collateral received by a fund is <u>not</u> part of its investment portfolio; rather it is held to mitigate a different type of risk - counterparty risk. In addition to that, the liquidity risk management deals with the portfolio (asset side) of the CIS whereas collateral is part of the collateral management process. Responsible entities generally have a separate collateral risk management process in place and which will handle the liquidity of collateral amongst other things.

Consequently, EFAMA recommends that this 4th paragraph under Principle 11 is deleted.

Principle 12

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

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

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 tools or exceptional measures which could affect redemption rights may enable a liquidity issue to be "managed", by in some way restricting investor redemption rights, it is preferable to avoid this if possible (see principle 4 above). Where a responsible entity has a choice as to whether to apply a tool or exceptional measure 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.

An example of an "indirect" factor that could be considered in identifying potential liquidity issues is the performance of the CIS relative to its peer group, where underperformance could lead to an increase in outflows and/or a decrease in new subscriptions.

Responsible entities should make best efforts to ensure future cash flows are as predictable as possible (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).

Referring to the end of the introductory sentence, EFAMA would like to remind that one cannot anticipate everything at any time, especially in anticipating large redemption requests.

With regard to the 2nd paragraph, please see comments under Principle 4. This paragraph again implies that tools are used when liquidity management has failed. Normal liquidity management tools are an integral part of the liquidity management process.

The inclusion of such 3rd paragraph under Principle 12 might be counter-productive in that, if a responsible entity felt obliged to increase liquidity because its CIS underperformed relative to its peer group, this could lead to further underperformance owing to greater cash/liquid asset holdings relative to other funds in the peer group or could actually incur improper behaviour from the fund manager who will hold cash for future outflows which may never materialise. Following this example could create a downward spiral which is not in the interests of investors. We suggest that the example be deleted.

Principle 13

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

In performing the liquidity risk management process, the responsible entity should consider quantitative and qualitative factors to ensure that in all but exceptional circumstances the CIS can always 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 predict liquidity risk. Consistent and verifiable statistical methods can be used to generate data and scenarios where appropriate – scenarios can relate to the behavior of investors and/or the CIS assets.

Ideally, responsible entities should have some degree of knowledge of the CIS's investor base, and where possible 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, a responsible entity could identify investors with a large unit-holding in the CIS, and keep up-to-date about 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.

EFAMA recommends being extremely cautious with the notion of "exceptional circumstances". Even in normal circumstances, the CIS might face i.e. operational difficulties to meet its liability. The first paragraph implies that the CIS is always sure to meet its liabilities, which could be too restrictive.

The responsible entity should then consider quantitative and qualitative factors to take all the necessary steps to ensure as much as possible that in all but exceptional circumstances the CIS can always meet its liabilities as they fall due.

EFAMA would also like to raise the fact that the development and use of scenarios relating to the behaviour of investors is very time consuming and the end result may not be conclusive because of the lack of reliable data and information (e.g. intermediated distribution channels do not provide proper information in terms of behaviour of investors).

If talking about institutional investors only, it may be easier to forecast the out- and inflows. Additionally, even if the information would be available, no pre-trading would seem possible to anticipate their investment decisions.

Moreover, information on redemptions from investors is often confidential and would only be given at the last minute to avoid market abuse trials.

EFAMA understands finally that the 4^{th} paragraph under Principle 13 as a suggestion to identify investors with a large unit-holding in the CIS, and keep up-to-date about whether they intend to make significant redemptions.

From an operational perspective, large asset management companies with many retail funds and multiple sales and distribution partners would find it very difficult to comply with such a requirement.

This might only be required where relevant, e.g. for funds with potential emerging liquidity shortages (identified based on the suggestions of Principle 12) or where a significant amount of assets invested in illiquid assets or some money market funds.
However, institutional funds should not be captured with those requirements as they usually have one large unit-holder which is in close contact with the respective client relationship manager and who directly negotiates large redemptions with its relationship manager.

Moreover, we query the need for this Principle. Indeed, Principle 1 already requires that an effective liquidity risk management process is put in place. We believe this renders Principle 13 redundant. Relevant parts of the accompanying commentary could be included under Principle 1.

Principle 14

The responsible entity should conduct assessments of liquidity in different scenarios, including stressed situations

As part of the implementation of the liquidity risk management process, appropriate assessments should be carried out by the responsible entity of the liquidity risk to the CIS in normal and stressed scenarios (for example, atypical redemption requests).
For example, the responsible entity could analyze the number of days that it would take to sell assets and meet liabilities in the stressed scenarios simulated. In respect of collateral an assessment could be used to demonstrate that the quantity of liquid assets is sufficient to meet settlement of margin calls on derivatives positions.
Assessments should be based on reliable and up-to-date information, and the results should be taken into account in performing and maintaining the liquidity risk management process. Feedback from any real situations experienced should be used to improve the quality of output from future assessments.
Responsible entities could also conduct assessments 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 such a downgrade can materially 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 cause unexpected redemption requests.
Assessments should be carried out at a frequency relevant to the specific CIS.

As expressed for Principle 11, EFAMA is of the opinion that the monitoring of collateral liquidity is very important but is a aprt of a manager's collateral management process, not its liquidity management process.

Additionally, EFAMA strongly recommends aligning the Principle 14 with the requirements currently in developments on the Regulation on OTC Derivatives, CCPs and Trade Repositories.

Finally, the industry experienced in 2008 that stress tests scenarios are very attractive but they are neither always feasible nor relevant. A pragmatic approach should always be possible to consider market conditions at the time CIS assets are traded. The liquidity risk management process may need to be adjusted from time to time in order to be applicable to current market conditions. Therefore, we would amend the Principle so that stress test scenarios are conducted where relevant.

Principle 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 exceptional measure 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 exceptional 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).

EFAMA would like to obtain some clarification on the introductory sentence. That sentence indicates that relevant disclosures are made for liquidity risk management process, but to whom? To potential investors or existing ones?

In the second paragraph, it is suggested that risk disclosure could be done in the annual report. As expressed several times in the commentary on previous Principles, EFAMA believes that this information might not be appropriate as, here again, it would provide too much and confusing information to investors. Annual reports are there to provide accounting information. We would again recommend using the KIID to deliver this type of information.

EFAMA believes that the disclosure requirements are governed by local law.
EFAMA, in 3rd paragraph under Principle, is concerned at the breadth of this paragraph and the fact that it could amplify liquidity risk. One has to think about specific markets where volatility is high, and the CIS would be forced to repeatedly communicate to investors, increasing again confusion, inducing panic and volatility.

For example, there could be a material change in liquidity which leads the operator to make use of existing and disclosed normal liquidity management tools. If the operator had to inform investors in these circumstances, such action could lead to a run on redemptions which in turn negatively impacts the CIS. Paragraph 3 should simply state that circumstances and nature of any disclosures is governed by local law.

EFAMA however agrees that where an exceptional measure, such as suspension, is implemented, investors should be notified. For the sake of clarity, EFAMA would however recommend the defining of the notion of “exceptional measures”.

We, consequently, recommend that the Principle be amended as follows:-

“The responsible entity should ensure that appropriate records are kept relating to the performance of its liquidity risk management process and relevant disclosures be made in relation to exceptional measures impacting the dealing policy of the CIS. It should also ensure compliance with the local jurisdictions disclosure requirements.”

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Brussels, 2 August 2012

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