110 Bishopsgate
19th Floor, Suites 19-06 and 19-07
London EC2N 4AY, UK
+44 (0) 207 961 0830
www.iciglobal.org

Suite 715–717, Level 7
Two Exchange Square
8 Connaught Place
Central, Hong Kong
+852 2168 0882

1401 H Street, NW
Suite 1200
Washington, DC 20005, USA
+001 202 326 5800
www.ici.org

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Submitted electronically to
consultation-04-2017@iosco.org and *consultation-05-2017@iosco.org*

Dr. Shane Worner
International Organization of Securities Commissions
Calle Oquendo 12
28006 Madrid Spain

Re: *Comments on IOSCO's CIS Liquidity Risk Management Recommendations and Open-ended Fund Liquidity and Risk Management—Good Practices and Issues for Consideration*

Dear Dr. Worner:

ICI Global[1] welcomes the opportunity to comment on two related International Organization of Securities Commissions (IOSCO) consultations on fund liquidity risk management: *CIS Liquidity Risk Management Recommendations* (Recommendations Consultation)[2] and *Open-ended Fund Liquidity and Risk Management—Good Practices and Issues for Consideration* (Good Practices Consultation).[3]

The ability to redeem shares is a defining feature of many of the funds we represent, including US mutual funds and exchange-traded funds (ETFs) and many regulated non-US funds.[4] Regulatory

[1] ICI Global carries out the international work of the Investment Company Institute, the leading association representing regulated funds globally. ICI's membership includes regulated funds publicly offered to investors in jurisdictions worldwide, with total assets of US$27.1 trillion. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of regulated investment funds, their managers, and investors. ICI Global has offices in London, Hong Kong, and Washington, DC.

[2] Available at: www.iosco.org/library/pubdocs/pdf/IOSCOPD573.pdf.

[3] Available at: www.iosco.org/library/pubdocs/pdf/IOSCOPD574.pdf. We refer to the Recommendations Consultation and the Good Practices Consultation together as the "Consultations."

[4] The Consultations are aimed at open-ended collective investment schemes (CIS), which IOSCO describes as "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

requirements and portfolio and risk management practices supporting redeemability are robust and have proved highly successful over time. Even so, in recent years, IOSCO and authorities in several jurisdictions have undertaken initiatives to enhance these requirements and practices. Given how important sound liquidity risk management is to regulated funds' ability to safeguard the interests of investors, we support IOSCO's current Consultations, subject to the comments we offer below.

We begin this letter with general observations on the Consultations (Section I). We then present our specific comments on the Recommendations Consultation and the Good Practices Consultation in Sections II and III, respectively. Section IV provides our closing thoughts.

I. General Observations

As IOSCO notes, policymakers, regulators, the asset management industry, and others have focused considerable attention on liquidity risk management in the asset management sector over the past few years, and IOSCO itself has devoted significant time and resources to the issue.[5] The Consultations build on IOSCO's earlier work while also seeking to respond to recent Financial Stability Board (FSB) policy recommendations[6] aimed at addressing what the FSB termed "residual risks associated with open-ended fund liquidity mismatch."[7]

We took strong exception to the "financial stability" premise upon which the FSB based its recommendations.[8] But we had few objections to the recommendations themselves, and were pleased that most called for IOSCO to conduct follow-up work.

Without question, it is appropriate for IOSCO, as the relevant subject matter expert, to lead this work. IOSCO's expertise is evident in the Consultations: they represent a sensible and measured step that should help promote a high bar across jurisdictions for funds' liquidity risk management practices.

We agree, too, with the approach IOSCO has taken. In particular:

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frequently." Recommendations Consultation at n.2. In this letter, we use the terms "fund" and "regulated fund" (or "regulated non-US fund," where appropriate) to refer to CIS meeting IOSCO's definition.

[5] *See* Good Practices Consultation at 2-3.

[6] FSB, *Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities* (12 January 2017) ("2017 FSB Report"), available at www.fsb.org/wp-content/uploads/FSB-Policy-Recommendations-on-Asset-Management-Structural-Vulnerabilities.pdf.

[7] *Id.* at 16.

[8] *See* Letter to the Financial Stability Board from Paul Schott Stevens, President & CEO, ICI, dated September 21, 2016, (2016 FSB Letter), available at www.ici.org/pdf/16_ici_fsb_ltr.pdf.

- We strongly support IOSCO's decision to supplement its 2013 report, *Principles of Liquidity Risk Management for Collective Investment Schemes,* rather than start anew. [9] Even before the release of these Consultations, IOSCO's work on fund liquidity risk management (including the 2013 Report) has been thoughtful and comprehensive and was not in need of substantial revision or enhancement.

- We commend IOSCO for recognizing that any recommendations directed to regulatory authorities "will have to be transposed within the context of the specific legal structures prevailing in each jurisdiction" and, therefore, how they are implemented may vary from one jurisdiction to another. [10]

- We agree with IOSCO's decision to prepare two Consultations—one with recommendations directed to relevant authorities and the other offering good practices for consideration by regulators, industry, and investors. We think having two documents that serve these different but complementary purposes is a very sensible way to proceed in this area.

- We give IOSCO credit for crafting the Consultations in a manner that appropriately focuses significant attention on investor protection considerations. As IOSCO notes in the Recommendations Consultation, "[e]ffective liquidity risk management is important to safeguard the interests and fair treatment of investors, and maintain the orderliness and robustness of [collective investment schemes] and markets."[11]

In general, the Consultations reflect an understanding that there is no "one-size-fits-all" approach to liquidity risk management. IOSCO correctly acknowledges that a fund manager must manage liquidity considering the specific characteristics of each fund, including its portfolio holdings; investment objectives, policies, and strategies; relevant market conditions; the composition of its investor base; and any tools the manager may have at its disposal.[12] Any applicable regulatory scheme should accommodate these necessary variations, ideally by taking a principles-based approach that leaves appropriate room for a range of good practices and the exercise of judgment. Responsible entities for ETFs, for example, should be able to modify practices as appropriate to manage the liquidity needs of this type of CIS.

More difficult to capture in any written document is the dynamic nature of the liquidity risk management process—a factor that likewise weighs against the imposition of rigid regulatory standards

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[9] IOSCO, *Principles of Liquidity Risk Management for Collective Investment Schemes* (March 2013) (2013 Report), available at: www.iosco.org/library/pubdocs/pdf/IOSCOPD405.pdf. Building upon this previous work also is consistent with the FSB's instructions to IOSCO in the 2017 FSB Report to "review its existing guidance and, as appropriate, enhance it."

[10] Recommendations Consultation at v.

[11] *Id.* at iv.

[12] *See, e.g.*, Good Practices Consultation at 3-4.

or overly detailed guidance. We encourage regulators to keep this in mind as they evaluate IOSCO's recommendations.

II. Comments on the Recommendations Consultation

In this Section, we provide comments on IOSCO's proposed recommendations and accompanying guidance. As in the Recommendations Consultation, our comments are organized by topic: the CIS design process; day-to-day liquidity management; and contingency planning.

A. CIS Design Process

Investments in less liquid assets

This section of the Recommendations Consultation contains two statements about funds investing in less liquid assets that we find troubling. We do not believe IOSCO meant to suggest that funds offering frequent redemptions should refrain from investing in less liquid assets or that such investments do not belong in funds offered to retail investors. To avoid any possibility for misinterpretation, however, we urge that IOSCO make the minor revisions described below before finalizing its report.

First, the guidance accompanying Recommendation 3 (dealing frequency) suggests that 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." Irrespective of whether such market pressure exists, a responsible entity's decision as to dealing frequency for a fund must be made in accordance with its legal obligations to the fund and other applicable requirements. And, from a more practical standpoint, a responsible entity will not wish to jeopardize its reputation by designing a fund it does not think it can manage successfully. For these reasons, we recommend that IOSCO delete the above sentence from the guidance. Nothing would be lost by doing so, as the guidance already cautions that "[t]he ability . . . 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."[13]

Second, the guidance accompanying Recommendation 4 (relationship between dealing arrangements and fund investment strategy/underlying assets) explains that the use of side pockets as a "normal" liquidity management tool "is generally not suitable for CIS offered to retail investors because *illiquid or hard to value assets are not normally suitable for retail investors*."[14] The italicized language is stated far more broadly than necessary to convey that use of a side pocket—which, as the Good Practices Consultation explains, represents a separate interest in an illiquid investment—may be inconsistent with investor expectations. Moreover, the italicized language, if taken out of context, could erroneously

[13] This language was part of IOSCO's 2013 Report.

[14] Recommendations Consultation at 23 n. 49 (emphasis added).

suggest that funds offering daily redemptions should not invest in such assets.[15] We accordingly urge IOSCO to rephrase this part of the guidance (*e.g.*, by deleting the italicized language).

Appropriate level of disclosure

Recommendation 7 states that the responsible entity should ensure that "liquidity risk and its liquidity risk management process are effectively disclosed to investors and prospective investors." We recommend that IOSCO modify the recommendation slightly, so that it refers to disclosure regarding "liquidity risk and the management of such risk." As with all disclosure to investors, the guiding principle should be ensuring the disclosure of information that is material to investor decision making.[16] In this case, a general explanation as to how the responsible entity intends to manage the fund's liquidity risk—as opposed to the management process itself—is likely to be more relevant to investors as they evaluate whether to invest in, or remain invested in, the fund.

We note that the guidance accompanying Recommendation 7 is very detailed. We suggest that, at a minimum, IOSCO consider moving the list of possible additional disclosure items to the final Good Practices report.

B. Day-to-day Liquidity Management

Identifying liquidity challenges

As currently drafted, Recommendation 12 states that "[t]he liquidity management process should facilitate the ability of the responsible entity to identify an emerging liquidity shortage before it occurs." We recommend that IOSCO slightly modify the recommendation to state that "[t]he liquidity management process should facilitate early awareness by the responsible entity of emerging liquidity challenges." This rewording would alleviate two concerns. First, the current reference to a liquidity "*shortage*" may not adequately encompass the range of liquidity challenges that a fund could encounter. Second, there are practical limits on a responsible entity's ability to identify an emerging liquidity challenge "*before it occurs*." This language suggests a degree of prescience that responsible entities simply do not have. Importantly, our proposed modifications to the recommendation are in keeping with IOSCO's expectations—that a responsible entity maintain a forward-looking perspective, be mindful of liquidity challenges that could occur, and manage fund liquidity risk accordingly.

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[15] In fact, fund regulatory schemes may allow open-end funds to hold illiquid positions up to a specified level. Consistent with longstanding guidance from the SEC, US mutual funds generally hold no more than 15 percent of their net assets in illiquid investments. The SEC recently codified a similar 15 percent standard. *See* Investment Company Act Rule 22e-4. In the case of UCITS, at least 90 percent of fund assets must be invested in transferable securities and money market instruments. *See* UCITS Directive 2009/65/EC, Article 50.

[16] *See, e.g.*, IOSCO, Objectives and Principles of Securities Regulation (June 2010), at 10: "Regulation should require disclosure, as set forth under the principles for issuers, which is necessary to evaluate the suitability of a collective investment scheme for a particular investor and the value of the investor's interest in the scheme" (citing Principle 26, Principles for Collective Investment Schemes).

IOSCO is proposing additional guidance to accompany Recommendation 12. We strongly support this language, which emphasizes the responsible entity's obligation to treat all fund investors fairly as it seeks to address any liquidity challenge facing the fund.

Ongoing liquidity assessments

We support Recommendation 14's focus on the need for a responsible entity to conduct liquidity assessments in different scenarios. Given the fundamental importance of a responsible entity's efforts to ensure that a fund stands ready to meet redemptions and other obligations, IOSCO appropriately calls for such liquidity assessments to be ongoing in nature. We likewise agree with IOSCO's conclusion that appropriate liquidity assessments may include approaches other than fund-level stress testing.[17]

The guidance accompanying Recommendation 14, however, focuses almost exclusively on stress testing arrangements. To make the discussion more balanced, we suggest that IOSCO consider retaining some of the guidance from the 2013 Report, which focuses on assessments more broadly. In particular, we would recommend retaining the following three paragraphs:

- 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).[18]

- 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 ("back-testing") should be used to improve the quality of output from future assessments.[19]

- Assessments should be carried out at a frequency relevant to the specific CIS.[20]

We also note that the guidance accompanying Recommendation 14 highlights several features that stress testing "should" have. Any discussion of possible stress testing features, in our view, belongs in IOSCO's final Good Practices report. Indeed, the Good Practices Consultation already contains an entire chapter on the topic of stress testing, providing information about the design of stress testing scenarios, governance and documentation, testing frequency, and use of

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[17] *See, e.g.*, Rule 22e-4 under the Investment Company Act, which requires a fund to assess, manage, and periodically review its liquidity risk, considering factors such as (i) its investment strategy and liquidity of portfolio investments during both normal and reasonably foreseeable stressed conditions, and (ii) its short-term and long-term cash flow projections during both normal and reasonably foreseeable stressed conditions.

[18] 2013 Report at 10.

[19] *Id.* at 11.

[20] *Id.*

testing results. This chapter easily could accommodate any discussion of possible stress testing features.

C. Contingency Planning

Development and testing

We support new proposed Recommendation 16 (periodic operational tests). Funds should be able to make prompt and efficient use of their liquidity management tools, if and when the need arises. Toward that end, planning in advance is essential and periodic testing is a useful exercise. Recommendation 16 and its guidance appropriately focus on the benefits of preparing for the potential use and testing of liquidity tools; outline relevant considerations; and leave it to funds to determine how to structure and memorialize their contingency planning. We recommend that IOSCO consider a minor addition to the guidance—namely, a statement acknowledging that funds must strike an appropriate balance between establishing clear policies and reserving the necessary latitude to evaluate specific (and possibly unanticipated) circumstances "in the moment" before determining whether to use a particular liquidity management tool.

Consideration of additional liquidity management tools

We agree with the premise that responsible entities should consider having a range of liquidity management tools at their disposal, as permitted under relevant law, with the goal of equipping themselves to best serve the needs, expectations, and interests of investors. We therefore support new proposed Recommendation 17 (availability and use of additional liquidity management tools), and commend IOSCO for framing it along these lines.

We recommend that IOSCO modify the guidance accompanying Recommendation 17 to highlight the operational considerations and challenges that can arise when evaluating whether to implement and use certain tools. This is a critical consideration for funds in some jurisdictions. For example, in 2016, the US Securities and Exchange Commission adopted rule amendments that will permit US mutual funds to use swing pricing.[21] Although swing pricing becomes legally permissible in the United States beginning in 2018, it remains to be seen whether or when US mutual funds will have the operational ability to implement it.[22] We therefore suggest that IOSCO revise the applicable sentence as follows: "There are a number of considerations, ~~related to~~ including the specific market conditions, operational

[21] *Investment Company Swing Pricing*, SEC Release No. IC-32316 (Oct. 13, 2016), available at www.sec.gov/rules/final/2016/33-10234.pdf

[22] *See, e.g.*, Evaluating Swing Pricing: Operational Considerations Addendum, ICI, (June 2017), available at https://www.ici.org/pdf/ppr_17_swing_pricing_summary.pdf (finding that the operational hurdles to using swing pricing remain, and that currently there are no clear industry solutions).

considerations, and the characteristics of the fund and its investors, to be taken into account when assessing whether to use these tools."

III. Comments on the Good Practices Consultation

As noted above, we support IOSCO's decision to prepare a separate Good Practices Consultation. By making this thorough and well-presented resource available, IOSCO can help foster improvements in liquidity risk management practices across all jurisdictions. The Good Practices Consultation contains detailed chapters on (i) ensuring consistency between a fund's redemption terms and its investment strategy; (ii) liquidity risk management tools; and (iii) stress testing. It also provides helpful context regarding the heightened focus on liquidity management in recent years and IOSCO's work in this area. And it properly recognizes that "the key responsibility of proper liquidity risk management primarily lies with the asset manager, including the calibrations as well as the decision to implement any tools."[23]

Consistency between redemption terms and investment strategy

The chapter on ensuring consistency between a fund's redemption terms and investment strategy is comprehensive. We fully agree that "appropriate valuation policies and procedures are of paramount importance to guarantee fair treatment to investors in the ongoing liquidity risk management of the fund."[24] As IOSCO has previously noted, "If CIS portfolio securities and assets are incorrectly valued, CIS investors may unfairly pay more for their shares (or unfairly receive less upon redemption), and investors remaining in the CIS also may be adversely affected."[25] While liquidity and valuation are related, funds' practices and regulatory requirements with respect to each may differ in important and appropriate ways. IOSCO simply should emphasize the investor protection benefits of strong valuation policies and procedures and liquidity risk management practices. Accordingly, we recommend revising the last three sentences in the sixth full paragraph on page 18 to state the following: "In situations where asset market liquidity deteriorates and redemption pressures arise, fund asset valuations should adequately and promptly adjust to the new market conditions, to ensure that investors who redeem receive a fund price per unit that is in line with the current market. If the fund's asset valuations do not reflect the current market, redeeming shareholders may not receive their pro-rata share of the fund's net assets."

In addition, with respect to the discussion of sales of fund assets to meet redemptions, IOSCO acknowledges on page 19 that a slicing approach "may not always be the best option to protect the interest of all investors." We agree. Fund managers must be mindful of several risks and other considerations in managing a portfolio, and may have very good reasons for selling investments in a

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[23] Good Practices Consultation at 4.

[24] *Id.* at 18.

[25] IOSCO, *Final Report on Principles for the Valuation of Collective Investment Schemes* (May 2013), available at www.iosco.org/library/pubdocs/pdf/IOSCOPD413.pdf.

non-*pro rata* way.[26] Consequently, we recommend that IOSCO make corresponding changes to an earlier sentence in the same paragraph, so that it reads: ". . . divestment ~~should~~ may be performed according to a 'slicing approach,' aimed at keeping the fund liquidity risk profile unchanged."

Liquidity risk management tools

We find IOSCO's discussion of liquidity risk management tools to be particularly helpful. The information it provides is both thorough and balanced—including a description of each tool, possible advantages and disadvantages to use of the tool, relevant examples and/or short case studies illustrating how different tools have been implemented, and information on how certain jurisdictions regulate the use of particular tools. In addition, the even-handed "pros and cons" tables for each tool helpfully reinforce the need for discretion and care in implementing, using, and regulating liquidity tools.

We also wish to highlight the examples IOSCO provides of cases in which "large redemptions from funds have not led to the activation of liquidity management tools, nor has there been any substantial impact on asset prices or the broader financial system."[27] Instances in which funds have navigated stressed conditions successfully provide important context, and have sometimes been neglected in the policy debate about fund liquidity. We note that IOSCO provides no counterexamples in which large redemptions of regulated stock and bond funds *did* have a substantial impact on asset prices or the broader financial system—nor are we aware of any.

As for considering when the activation of liquidity management tools may be appropriate, we concur with the two "overarching principles" IOSCO suggests should govern these decisions: (i) "the use of a mechanism that affects redemption rights is only justified in open-ended funds in exceptional circumstances;" and (ii) "the use of such extraordinary tools must be in the best interest of the fund investors collectively."[28] We also agree with IOSCO's accompanying observations, including that "exceptional circumstances are rare."[29]

IV. Closing Thoughts

The Consultations represent an important contribution to the public record surrounding a multi-year policy debate about liquidity and redemption risks associated with open-ended investment funds—a debate that unfortunately has been fueled, at times, by unsubstantiated theories about these risks. As IOSCO points out, "[i]n general, open-ended funds have historically been able to manage their day-to-

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[26] *See, e.g.*, Letter to the SEC from Brian Reid, Chief Economist, ICI, dated January 13, 2016, at 32-33, available at www.sec.gov/comments/s7-16-15/s71615-56.pdf ("Our understanding, however, is that funds use a much more nuanced approach to meeting redemptions, with their actions guided by market conditions, expected investor flows, and other factors.").

[27] Good Practices Consultation at 20-21.

[28] *Id.* at 22.

[29] *Id.*

day liquidity requirements even during periods of high redemption demand."[30] We appreciate IOSCO's reference to an Appendix to ICI's 2016 FSB Letter as support for this statement. In that Appendix, we examined the experiences of US, European, and Canadian bond funds during periods of market stress following the global financial crisis. Based on empirical data regarding the behavior of fund investors, fund managers, and other market participants, we found that fund investors in aggregate reacted quite modestly to those periods of market stress.[31]

More importantly, the data and analysis in our Appendix contradict certain hypotheses that have been perpetuated about the behavior of open-ended funds, their managers, and their investors in response to stressed market conditions. In our view, the Appendix illustrates the need for the policy community to reexamine these hypotheses based on empirical evidence. We urge IOSCO to endorse such a reexamination. Otherwise, speculative theories (*e.g.,* about the potential for massive fund redemptions leading to fire sales of assets with negative effects on markets and other market participants) will persist and proliferate,[32] which has the potential to lead to bad policy outcomes.

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We appreciate the opportunity to comment on the Consultations. If you have any questions regarding our comments or would like additional information, please contact me at (011) 44-203-009-3101 or dan.waters@iciglobal.org; or Susan Olson, Chief Counsel, ICI Global, at (202) 326-5813 or susan.olson@iciglobal.org.

Sincerely,

/s/ Dan Waters

Dan Waters
Managing Director
ICI Global

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[30] *Id.* at 20. IOSCO cites "some money market funds" as an exception, but notes that regulatory reforms have been implemented (or are in the process of being implemented) in many jurisdictions to address issues that arose during the 2007-09 global financial crisis.

[31] The 2016 FSB Letter and Appendix are available at www.ici.org/pdf/16_ici_fsb_ltr.pdf.

[32] *See, e.g.*, 2016 FSB Letter at 10-17; Letter to the FSOC from Paul Schott Stevens, President & CEO, ICI, dated July 18, 2016, available at https://www.ici.org/pdf/16_ici_fsoc_ltr.pdf.