Frankfurt am Main,
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BVI[1] position on IOSCO's consultation on CIS liquidity risk management

BVI takes the opportunity to present its views on the consultation on collective investment schemes (CIS) liquidity risk management recommendations[2] (hereinafter 'consultation paper') and the consultation report on good practices and issues for open-ended fund liquidity and risk management[3] (hereinafter 'consultation report').

Following the FSB's recommendations[4] to address structural vulnerabilities deriving from asset management activities, we support the initiative to review IOSCO's principles[5] of liquidity risk management for CIS published in 2013. These principles already set a high standard in the area of liquidity risk management. Moreover, it is important to highlight that as a consequence of the financial crisis very strict legal requirements in the asset management sector have already been implemented in the European Union, in particular in the field of liquidity management. However, in avoiding liquidity mismatch between fund investments and redemption terms and conditions for shares/units of open-ended funds, we see the need to amend IOSCO's liquidity risk management principles with certain recommendations and explanations. However, the amendments should be in line with the FSB's recommendations. In particular, this applies for the newly drafted principles on stress testing and disclosure to investors. It is of utmost importance that these requirements consider that managing liquidity risks needs to be observed in the overall context of the individual fund's portfolio including the investment objective, the investment instrument and redemption terms. All of these issues have a different effect on the liquidity. We therefore do not support a one-size-fits-all approach but rather an approach of flexibility for the asset manager.

In particular, we consider investment funds to dampen systemic risks in general as they can balance between investors who want to divest and those who want to invest in a financial market. In the absence of investment funds these investors would have to access the markets directly. If regulators introduce too detailed and restrictive rules on liquidity management for investment funds, asset managers would be forced to act in a similar way during a possible liquidity crisis. This could lead to an amplification of the crisis rather than mitigation. Therefore, we think that a very detailed regulation approach could also increase systemic risks. As a consequence and as a more general comment to the questions, we would like to stress that jurisdictions should provide asset manager a wide range of liquidity risk management tools. Depending on the types of investment funds established in the different markets, in principle, all liquidity risk management tools set out at the end of 2015 in IOSCOs report[6] should be made available to investment funds. However, in every case, it should be the discretion of the man-

[1] BVI represents the interests of the German fund industry at national and international level. The association promotes sensible regulation of the fund business as well as fair competition vis-à-vis policy makers and regulators. Fund companies act as trustees in the sole interest of the investor and are subject to strict regulation. Funds match funding investors and the capital demands of companies and governments, thus fulfilling an important macro-economic function. BVI's over 100 members manage assets of nearly 3 trillion euros for private investors, insurance companies, pension and retirement schemes, banks, churches and foundations. BVI's ID number in the EU Transparency Register is 96816064173-47. For more information, please visit www.bvi.de/en.
[2] IOSCO, Consultation on CIS Liquidity Risk Management Recommendations, July 2017, available at: https://www.iosco.org/library/pubdocs/pdf/IOSCOPD573.pdf.
[3] IOSCO, Consultation Report, Open-ended Fund Liquidity and Risk Management – Good Practices and Issues for Consideration, July 2017, available at: https://www.iosco.org/library/pubdocs/pdf/IOSCOPD574.pdf.
[4] FSB, Policy Recommendations, January 12, 2017, available at: http://www.fsb.org/wp-content/uploads/FSB-Policy-Recommendations-on-Asset-Management-Structural-Vulnerabilities.pdf.
[5] IOSCO, Principles on Liquidity Risk Management for Collective Investment Schemes, Final Report, Report of the Board of IOSCO, March 2013, available at: http://www.iosco.org/library/pubdocs/pdf/IOSCOPD405.pdf.
[6] IOSCO, Liquidity Management Tools in Collective Investment Schemes: Results from an IOSCO Committee 5 survey to members Final Report, available at: https://www.iosco.org/library/pubdocs/pdf/IOSCOPD517.pdf.

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ager of the funds which tool they want to use because of very different fund types and structures. It is in the very own interest of every asset manager to create a portfolio that provides effective tools to manage liquidity risks.

I. Scope of the 2017 Liquidity Recommendations (consultation paper)

Q 1*: The 2013 Liquidity Report related to open-ended CIS and where determined by the responsible entity, to some closed-ended CIS. Should the proposed text laid out below apply also to the same range of CIS? Should certain CIS or types of CISs be excluded from any particular requirements, or be subject to a different requirement, because of their investment strategies, ownership concentrations, redemption policies, or some other factor that makes them more or less prone to liquidity risk?*

Liquidity risk management is very important and sufficient for all investment funds which have to fulfil any payment obligations on behalf of the fund and/or any requests of investors to redeem its units. However, we see the need to distinguish between the microprudential level with focus on investor protection and the macroeconomic and structural viewpoint with focus on stabilisation of the financial markets as a whole. We would like to highlight that the FSB emphasised the potential mismatch between the liquidity of the fund investments and redemption terms and conditions only applies for open-ended funds as a key structural vulnerability from asset management activities. Therefore, the scope of the new liquidity risk management principles should be limited to open-ended investment funds.

However, a liquidity risk management process for leveraged closed-ended investment funds is also required under the European Directive 2011/61/EU (AIFMD). The focus here is on liquidity management at portfolio level while being exempt from specific redemption-related liquidity management requirements. The potential mismatch between the liquidity of the fund investments and redemption terms highlighted by the FSB as a key structural vulnerability can not materialise in closed-end investment funds.

Moreover, we request IOSCO to implement a principle-based approach for the scope of the new text. The application of liquidity risk management requirements should be adapted to the size, structure and nature of the open-ended investment funds. In particular, the following criteria should be considered:

- Frequency of redemption of fund units (daily, short-term, long-term)
- Investment strategy: The liquidity requirements of fund investments should be adjustable depending on the strategy.
- Categories of investors (retail or professional): The knowledge and experiences in financial markets will usually depend on the type of investors. The potential risk that the investor may overestimate the liquidity of the assets held by the fund is much more limited in cases where the investment fund has professional investors only. Moreover, investment funds designed exclusively for professional investors such as banks or insurance undertakings also have to fulfil special reporting requirements about the composition of the portfolio vis-à-vis the investors because of their special regulatory requirements (such as the Basel framework for banks implemented in Europe under the Capital Requirements Directive or for insurance undertakings under the European Solvency Directive).
- Number of investors: If the number of investors is limited and these investors are known by the manager, it is easier to estimate any liquidity risks such as large redemptions.

Finally, exemptions should be made for ETFs due to their very limited relevance of liquidity risks to the ETFs' business model (for more detail, we refer to our answers to questions 5 and 6).

II. Good Practices Document (consultation report)

Q 2: *Do respondents agree with the general considerations around liquidity risk management? Are there other issues that should be included?*

We agree with the general considerations around liquidity risk management, in particular with the explanations in Chapter 3 of the consultation report about ensuring consistency between a fund's redemption terms and its investment strategy. The given examples demonstrate the current practice how measures to address liquidity risk management take into consideration the specificities of investment funds and their individual features. They also show the large diversity of investment strategies and redemption policies which result in different approaches for liquidity management processes. There is no place for a–one-size-fits-all approach. Therefore, the new IOSCO's liquidity risks management recommendations should be principle-based to reflect the range of these kinds of different open-ended investment funds.

Q 3: *Does the Good Practices Document cover the key considerations regarding liquidity risk management tools, including their use in normal and stressed scenarios? Are there other issues that should be considered? Are there other key tools that should be included? Do you agree with the pros and cons in regards to the use of each tool? Are there other pros and cons that should be considered?*

In our view, the consultation report covers the key considerations regarding liquidity risk management tools. The consultation report sets out clearly, for a large number of jurisdictions, the various frameworks and policy tools currently at the disposal of asset managers and the scope of funds to which they apply. We do not believe there are other issues that should be considered, at least at the present stage.

Q 4: - *Do you agree with the general considerations regarding stress testing? Are there other issues that should be included?*

We agree with the background of stress testing explained in the consultation report. However, references to the legal requirements of the European Implementing Directive 2010//43/EU of 1 July 2010 implementing the UCITS Directive 2009/65/EC (UCITS Implementing Directive) should be added. According to Article 40(3) Subparagraph 2 of the UCITS Implementing Directive, UCITS management companies shall, where appropriate, conduct stress tests which enable assessment of the liquidity risk of the UCITS under exceptional circumstances. In addition, CESR's Risk management principles for UCITS[7] propose a framework for guidelines concerning risk management, including principles with regard to stress tests (cf. explanations under Box 7 of the Risk management principles).

With regard to the other issues on stress testing, we would like to highlight that our concerns on the proposed new recommendations in the consultation paper should also be considered in the final report of good practices (please see our answers to questions 11-15).

Furthermore, the consultation report references to requirements of a very few number of regulators such as the Asset Management Association of China (AMAC), the French Autorité des Marchés Financiers (AMF France) and the Hong Kong Securities and Futures Commission (HKSFC). It appears that

[7] CESR, Risk management principles for UCITS, February 2009, Ref: CESR/09-178, available at: https://www.esma.europa.eu/sites/default/files/library/2015/11/09_178.pdf.

these requirements are copy-pasted as a common standard for all investment fund managers and authorities. On the other hand, IOSCO notes that an authority has to consider their local market conditions or other regulatory specificities and priorities. In this context, we see the need to clarify the relationship between the two documents, the consultation paper with the proposed new recommendations on liquidity risk management principles on the one hand and the consultation report with examples of good practices on the other hand. It appears that some of the given examples in the consultation report are also requirements which should be taken into account by the other authorities. **Therefore, it must be clarified that other authorities which do not have established their own stress test guidelines at the current stage are not required to do so in the same manner. We therefore understand the proposed Chapter 5 of the consultation report about stress testing only as examples.**

Moreover, it is important to keep in mind that the current European requirements on liquidity management (including stress tests) under the AIFMD and UCITS Directive already consider the broad range of different types of investment funds and give a flexible approach in implementing stress tests depending on their size, investment strategy, investor base etc. Therefore, the final recommendations which are part of the consultation paper should reflect the current legal requirements and set standards on a more principle-based approach. This would be in line with the FSB recommendation 6. In view of the broad variety of investment strategies, it is impossible to establish common reference parameters of the stress tests scenarios to be included in the stress tests on the fund level for all open-ended investment funds. Otherwise, we see the danger that a prescriptive approach might create systemic risk if all fund managers use the same methodology and – as a consequence – are invested in the same assets.

Finally, we would like to highlight that also our members have established principles at the end of 2016 with regard to stress tests as part of BVI's guidelines on measures to assess liquidity risks of open-ended retail investment funds (**Annex 1**, only available in German).

III. Exchange-Traded Funds (ETFs)

Q 5: Should ETFs be subject to different liquidity requirements than other CIS?

a) If not, should ETFs be included within the scope of the 2017 Liquidity Recommendations?

(i) If yes, are changes needed to be brought to the 2017 Liquidity Recommendations to reflect ETFs specificities? Which ones?

(ii) If not, please explain why ETFs should not be included within the scope of the 2017 Liquidity Recommendations if they have partly similar liquidity issues as other CIS.

b) If ETFs should be subject to different liquidity requirements than other CIS, what should they be?

In Europe, most ETFs are authorised as UCITS and thus are bound by the general liquidity management rules under the UCITS Directive. However, as elaborated by IOSCO in section 2.4.1 of the consultation paper, the way liquidity supply works for ETFs is substantially different from the mechanisms common in other investment funds. Retail investors usually cannot redeem or subscribe ETF shares from the fund provider, but need to trade such shares at the secondary market where the Authorised Participant (or AP) provides buy and sell quotes throughout the day. In the European market, direct subscriptions and redemptions of ETF shares by the AP are typically possible on an in-kind basis meaning that the AP may subscribe to the ETF or be redeemed in exchange for a specific basket of securities or other assets relevant to the ETF's exposure. Moreover, it should be noted that while the AP has no regulatory duty to provide liquidity, it is common to impose a contractual obligation on the AP to ensure continuous pricing of ETF shares under normal market conditions.

Against this background, it is clear that the new 2017 Recommendations which focus on management of a fund's dealing frequency towards investors and ensuring sufficient liquidity supply in this regard are not specifically relevant for ETFs. In particular, ETFs cannot make any reasonable use of the additional liquidity management tools and other measures aiming to prevent a liquidity shortage at the fund level in order to satisfy redemption requests from investors. Similarly, most ETFs follow index-tracking strategies and thus have virtually no discretion to account for liquidity management aspects in the management of their portfolios. This applies in particular for ETFs physically investing in securities of which a reference index is composed.

On balance, we are therefore of the opinion that ETFs should not be subject to the 2017 Liquidity Recommendations as envisaged by IOSCO due to their very limited relevance to the ETFs' business model. Should any issues arise in relation to either liquidity risk inherent in ETFs or its disclosure to investors, then some targeted amendments to the existing IOSCO Principles for the Regulation of Exchange Traded Funds from 2013 could be considered. However, for the avoidance of doubt, we have as yet not identified any liquidity issues concerning ETFs which would merit such an initiative.

***Q 6: -** Are there key liquidity related issues specifically regarding ETFs?*

As indicated in our reply to Q6 above, we have not as yet identified any particular issues in terms of liquidity risk management relevant specifically to ETFs. This applies also in relation to the potential problems discussed by IOSCO in section 2.4.2 of the consultation paper:

- **Liquidity cost in case of in-kind redemptions:** There is indeed the risk that in case of declining liquidity of an ETF's underlying assets, any transfer of such less liquid assets to the AP would result in increased bid-ask spreads for ETF trading. However, this risk is not unique to ETFs, but pertains to any instrument traded on the secondary market. The fact that bid-ask spreads will reflect a risk premium in case of deteriorating liquidity conditions could be also relevant to any other retail fund the units of which are subject to secondary market trading (in addition to direct subscriptions and redemptions). For the European market, it is also important to bear in mind that providers of UCITS ETFs are required to allow for direct redemptions by investors in cases in which the quotes available at the secondary market deviate significantly from the ETF's net asset value. The process to be followed in such circumstances shall be described in the prospectus of the ETF and its application in a specific event duly communicated to the market[8].

- **Significant redemptions could be passed to the ETF:** The risk that significant sales of ETF shares on secondary markets could lead to a redemption pressure at the level of the AP is mitigated in case of in-kind redemptions. This redemption model which is commonly used by European ETFs allows an ETF to return to the AP a specific basket of securities or other assets in exchange for the redeemed fund shares.

- **Cessation of AP's arbitrage operations/contingency arrangements:** As explained above, an AP is generally under a contractual obligation to ensure continuous pricing of ETF shares. Thus, a cessation of AP's operations should realistically be assumed only in case of market stress which would affect all market participants. Under such circumstances, however, the operating difficulties would also pertain to other market makers which renders contingency planning to tackle events of market stress very difficult from the ETF provider's perspective. In Europe, the regulator requires

[8] Cf. ESMA Guidelines on ETFs and other UCITS issues from 1 August 2014, para. 23 and 24.

the ETF in such cases to allow for direct redemptions of ETF shares by investors and to communicate this possibility to the market.

In general, trading of ETFs on secondary markets is not different from trading of other instruments such as ordinary shares and thus prone to the same challenges and risks. ETF providers have only limited influence on the operations of the appointed AP and secondary market in general. Hence, potential liquidity shortages in ETF trading should be primarily dealt with the context of the general market regulation. Any recourse to the ETF in order to obtain liquidity for satisfying redemption requests from investors should be treated as a last-resort measure applicable only in extraordinary events.

IV. Existing Recommendations

Q 7: *Does this guidance on the design phase process capture the best of current good practices in the design of CIS?*

- **Recommendation 3**

We would like to propose to amend the new drafted guidance under Recommendation 3 as follows:

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

In general, the determination of the dealing frequency in the context of the CISs investment strategy and objectives is an integrated part of the regular process within the design phase. The result of that part is incorporated in the prospectus and its conditions related to redemptions. As consequence of that, asset managers are acting for the purpose of their investors not only in normal market conditions but also in stressed conditions. For doing so we appreciate a wide variety of liquidity management tools cross all jurisdictions which will also help to reduce a herding effect by the potential use of a limited range of liquidity management tools.

In that context we would recommend to adapt the wording of 'strong assurance' and 'reasonably foreseeable (i.e. extreme but plausible)' within the last sentence. The change of the wording 'strong' is driven by the circumstance that investment strategy and the investment objectives are clearly predefined and documented and part of the daily management process. However, investor protection needs a flexible use of liquidity management tools including the suspension of redemptions which is difficult to subcategorize under 'strong assurance'.

Moreover, we propose to delete the second sentence. We agree that there could be cases in which the 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. However, this is only a justification for the need of making a significant design decision. IOSCO's principles should be limited to recommendations what the responsible entity has to do. This is already considered in the other sentences.

- **Recommendation 4**

a) We would like to propose to amend the new drafted Recommendation 4 as follows:

> *'The responsible entity should ~~**ensure**~~ **to be aimed** that the CIS' dealing (subscription and redemption) arrangements are appropriate for its investment strategy and underlying assets throughout ~~**the entire**~~ **an appropriate period of time of the** product life cycle, starting at the product design phase.'*

We recommend to adapt the wording within in the Recommendation 4 by 'ensure' to 'to be aimed' and 'entire product life cycle' to 'an appropriate period of time of the product life cycle' or to 'a foreseeable phase of the product life cycle' respectively. The latter one is even compulsory for CIS having no prefixed or limited life cycle. In such cases it is virtually impossible to take into consideration any possible event which might occur during the term of its operation, especially if the CIS portfolio is composed of assets for which no liquid market exists (e.g. open-ended property funds).

b) We would like to propose to amend the last sentence of the second paragraph under recommendation 4 as follows:

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

We recognize the element of knowing your investors but due to different intermediaries and distribution channels there is no assurance to get full transparency of all investors. As a consequence, it is difficult and to a certain extent not possible to know all investors, and the appraisal of the likely risk appetite of the investors and their potential behaviour in certain market conditions is difficult to assess and anticipate. Therefore the wording should be amended accordingly. Moreover, it should be taken into account that in some CIS redemption of units is possible only after expiry of a certain notice period which significantly facilitates liquidity planning. In that context we also refer to our answer to question 10.

c) We request IOSCO to amend the last paragraph under Recommendation 4 as follows:

> ***'Liquidity Risk Redemption-constraining 'Additional Liquidity Management Tools'***
> *Having completed the design phase analysis of liquidity of the proposed assets, the characteristics of target investors and the features of every-day liquidity management practices, the responsible entity should ~~**consider**~~ **identify** in the design of the CIS an appropriate range of additional liquidity management tools **that may be used** for managing redemptions to assist in the management of stressed market conditions, subject to applicable law and regulation and any regulatory requirements and provided it is in the best interest of unit-holders within the CIS.'*

It must be noted that the FSB highlights under its Recommendation 8 that asset managers have the primary responsibility to exercise exceptional liquidity risk management tools regarding the open-ended funds they manage. The FSB states that the decision to use such tools should generally remain with the asset manager because the manager is responsible for evaluating what is appropriate for a particular fund, in light of its investment strategies, the liquidity of its portfolio, current market conditions, and other relevant circumstances. **In every case, it is at the discretion of the manager of the funds which tool they want to use because of very different fund types and structures. Therefore, we request IOSCO to clarify this important approach under Recommendation 4** (please also see our remarks to Recommendation 17, Question 18).

Q 8: *Does Recommendation 7 capture appropriate additional liquidity disclosures?*

We request IOSCO to amend the first two paragraphs and the fourth of the additional guidance under Recommendation 7 as follows:

> *'The relevant disclosures concerning liquidity* ***risk and the liquidity risk management process*** *of the CIS should be properly designed taking into account the* ***liquidity risk profile of the CIS*** ***~~nature of the assets the CIS intends to invest in and the degree of sophistication of the investor profile~~****.*
>
> *Disclosures concerning liquidity* ***risk and the liquidity risk management process*** *have the potential to provide investors with information to determine whether their liquidity risk appetite matches the liquidity risk profile of the CIS. In particular, such disclosure is most likely to be beneficial where the CIS is invested in assets or instruments which have a record of significantly varying liquidity across the financial cycle or where there is insufficient historical evidence to assess whether liquidity will vary significantly across the financial cycle.*
>
> *…*
>
> *The* ***periodic*** *disclosure of the liquidity* ***risk*** *of assets to investors may be transparently done by profiling the* ***~~projected or~~*** *actual asset portfolio/asset class(es) which the CIS is currently* ***~~or expected~~*** *to invest in. At the time of the launch of the CIS, disclosure of liquidity* ***risk*** *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 [risks] should be balanced against maintaining confidentiality where this is in the interests of investors, sufficient detail should be disclosed to make investors aware of material liquidity risks.~~****'*

Disclosure to investors is of paramount importance to protect those investors. However, disclosure requirements to investors should only comprise of a summary of the general implemented liquidity process for the fund and its general liquidity risk. In line with the principle of differentiation, and recognising the diversity of types of open-ended investment funds, the disclosure to investors required of a fund should vary according to the type of the fund and would depend on its individual liquidity risk profile. Therefore, we refer to the information which should be disclosed to investors required under the AIFMD (prospectus and annual reports) and which are sufficient and detailed enough to inform investors about the liquidity risks of investment funds.

In this context, we disagree with the assumption that in any case the 'degree of sophistication of the investor profile' should be taken into account. In particular, in most cases, the manager's knowledge on the investor's degree of sophistication is limited, especially on retail investors. Moreover it is neither the duty of the asset manager nor possible to know the individual investors and their risk profiles as the fund investment is only a part of their overall investments. At most, asset managers can only act with regard to investor types or categories. As a consequence, asset managers distinguish by the characteristics within the 'general risk information' (please refer to our example below in Box 1). In case of an investment fund with a limited number of investors (such as professional investors), there usually is a 'one-to-one' relationship and therefore a higher level of interaction. That circumstance brings asset managers in a position to better asses the investor profile. We therefore propose to take, in general, the liquidity risk profile of the CIS into account which also includes the effects of the investor profile of the liquidity management.

The wording of 'disclosure concerning liquidity' could be misunderstood as a disclosure of actual liquidity levels, e.g. as a percentage of the AUM. Therefore, it should be clarified that the liquidity risks and the liquidity risk management process should be disclosed. This would be in line with Recommendation 7.

We propose to distinguish in the fourth paragraph under Recommendation 7 between periodic disclosure and disclosure in the offering documents. It is common practice to disclose the composition of the portfolio (actual asset portfolio/asset classes) in the regular reporting such as annual reports.

Box 1: Illustration of liquidity risks within the general risk information in Germany (Example)

'Risks of reduced or increased Fund liquidity (liquidity risk) and risks associated with increased subscriptions or redemptions (liquidity risk): Below is an outline of the risks that may restrict the liquidity of the Fund. These may cause the Fund to be temporarily or permanently unable to fulfil its payment obligations, or cause the Company to be temporarily or permanently unable to comply with redemption requests from investors. Investors may then be unable to realize their intended investment duration, and be unable to use their invested capital or parts thereof for an indefinite period of time. The materialization of liquidity risks may also cause a decrease in the value of the Fund and thereby a decrease in the unit value, for example, if the Company were forced to sell assets on behalf of the Fund at less than their market value, subject to legal restraints. If the Company is not in a position to meet investors' redemption requests, this could also lead to redemptions being suspended and, in extreme cases, to the subsequent liquidation of the Fund.'

Q 9: *Should additional wording be included in Recommendation 12 concerning how responsible entities should proceed when faced with the need to sell assets to the extent that might lead the CIS to vary from its investment strategy?*

No. It is important to state that liquidity management depends on the types of assets, investors, investment strategies, markets, and possible national legal or contractual restrictions under the investment funds' rules for changing investment strategies. In particular, such restrictions could not allow the need to sell assets contrary to the investment strategy disclosed to investors. In our view, it is more important that all liquidity risk management tools set out at the end of 2015 in IOSCO's report should be made available to funds. However, in every case, it should be at the discretion of the manager of the funds which tools they want to use because of very different fund types and structures. The use of liquidity management tools should be made dependent on concrete circumstances and should vary according to the nature, scale and investment strategy of the CIS. As a last resort, the redemption should be suspended under the precondition that no other alternative is available under the fund rules or other potential liquidity management tools are considered to be inappropriate.

As we understand the FSB recommendations, the liquidity risk management process should facilitate the ability of the responsible entity to identify an emerging liquidity shortage before it occurs. We want to highlight that it is difficult to anticipate emerging liquidity shortages before they occur or before they are obvious for market participants. Nevertheless there are processes and controls in place to monitor redemptions and a change of the redemption volumes and to observe indications of changes in market liquidity. Therefore, we are in line with the proposal that, for example, one appropriate instrument could be the monitoring and management of large redemptions by investors. However, the requirement that this should involve ensuring that remaining investors are not left with a disproportionate share of potentially illiquid assets, is not feasible. Legal requirements or the investment funds guidelines could only require the circumstances under which investors could use liquidity management tools. Ensuring that remaining investors are not left with a disproportionate share of potentially illiquid asset could only be a desirable objective. Therefore, we propose a more principle-based approach such it is required under the AIFMD[9]. According to European law, the manager considers and puts into effect the tools necessary to manage the liquidity risk of each investment fund and shall identify the types of circumstances where these tools may be used in both normal and exceptional circumstances, taking into account the fair treatment of all investment funds' investors in relation to each investment fund under management.

Box 2: Internal liquidity thresholds as an early warning system based on BVI redemption analysis of German open-ended retail funds

Analysis of the German open-ended retail investment fund market shows that investment management companies for the most part are able to manage liquidity risks in order to fulfil daily redemptions of fund units. In 2010, BVI assessed the issue of liquidity management for different kinds of securities funds such as equity, bond or mixed funds. In 2015/2016, BVI broadened the approach to open-ended property funds. In a nutshell, evidence showed that a liquidity ratio of 20 % can be considered as a robust prerequisite to fulfil redemption requests based on historical data. These results (cf. overview of BVI redemption analysis, **Annex 2**) were obtained on the basis of the following process:

The management company compares the liquidity ratio of the fund with determined changes of outflows based on historical BVI statistical data for the relevant fund's category. If the liquidity ratio of the fund is higher than the ratio of short term outflows, in principle, the fund is safe from liquidity shortfalls. However, if the liquidity ratio is lower than the ratio of short term outflows, the management company should assess further aspects which imply further possibilities for action (such as analyses of the historical short term outflows of the specific fund, analyses of the current unit holder structure, assessment of the expected future short term outflows, special borrowing facilities etc.).

- **Determination of the liquidity ratio of the fund:** As a first step, the management company assesses whether the assets in which the investment fund is invested are liquid or not, resp. evaluates the degree of liquidity. Then it determines the liquidity ratio of the fund as the ratio between the value of the liquid assets and the net asset value of the fund (NAV). This process is also in line with the current requirements of the AIFMD2 according to which the manager is obliged to maintain a level of liquidity in the investment fund appropriate to its underlying obligations, based on an assessment of the relative liquidity of the investment fund's assets in the market, taking account of the time required for liquidation and the price or value at which those assets can be liquidated, and their sensitivity to other market risks or factors.

  In this context, it is important to highlight that there is no need for a global and common guidance related to open-ended funds' investment in illiquid assets such as whether certain asset classes and investment strategies may not be suitable for an open-ended fund structure (please see also our comments to question 6) as well as an abstract classification of the liquidity of asset categories (for example as proposed by the SEC). In particular, FSB and IOSCO should avoid setting too strict binding requirements on liquidity analysis of assets. Otherwise we see the danger that the management company might not be able to react to changes in the market and they could make decisions with some of evidence of "herd behavior" with further impact to new (systemic) risk. Such requirements would also pose administrative burdens for the management companies. Therefore, it is important that liquidity management should be based on a case by case assessment.

[9] Cf. Article 47(1)e) of the Delegated Regulation (EU) No 231/2013.

- **Outflows of the fund resulting from redemptions of units:** The assessed liquidity ratio of the fund then should be compared to the average redemption situation of the relevant fund category ascertained on a historical basis. For this purpose, BVI has conducted statistical evaluations based on the BVI investment fund statistics between 2003 and 2015 (based on over 7,100 retail funds and monthly cumulative changes of the funds' outflows).

As a result, significant redemptions of more than 20 percent of the NAV occurred in 2 to 4 percent of all samples on a monthly basis, depending on fund categories such as equity funds, bond funds and mixed funds. Many of these cases can be explained by exceptional market conditions or movements (e.g. times of crisis, collection of profits etc.). After the financial crisis of 2008, management companies funded nearly all outflows without the use of additional liquidity management tools.

BVI subjected the biggest outflows identified for different fund types to analysis of another random sample in order to gather insights regarding the liquidity needed on a daily basis. The significant outflows focus on very few days within a month (3.7 days on average) and occur selectively. They relate to occurrences which were known beforehand (e.g. money market funds which are used for liquidity management by the management company itself: foreseeable need of liquidity etc.). The liquidity needed on a daily basis in case of significant outflows amounted to 18 percent on average within the new random sample. These results support those gathered from the data collected on a monthly basis only.

In summary, when looking back to the post-crisis scenario after 2008, significant outflows first increased and later decreased slightly, but not to the pre-crisis level. However, the average levels of significant net outflows did not change over time.

Q 10: *Does the proposed additional guidance under Recommendation 13 constitute the appropriate approach for a CIS to assess its redemption obligations and liabilities? If not, what else would you suggest?*

We strongly disagree with the proposed new guidance under Recommendation 13 regarding the knowledge of the investor base. We therefore propose to maintain the current wording that 'ideally, responsible entities should have some degree of knowledge of the CIS's investor base, and where possible should interact with relevant intermediaries …'

It must be noted that the FSB only states under its Recommendation 3 that authorities should have requirements or guidance stating that funds' assets and investment strategies should be consistent with the terms and conditions governing fund unit redemptions both at fund inception and on an ongoing basis (for new and existing funds), taking into account the expected liquidity of the assets and **investor behaviour** during normal and stressed market conditions. The FSB does not recommend to analyse the investor base in detail. If there is a need to give guidance on the assessment of investor behaviour, analyses of the outflows based on historical (statistical) data for the relevant fund's category (such as described under Box 2 above) could be helpful.

In general, it is difficult or impossible to identify an emerging liquidity shortage before it occurs by anticipating the potential behaviour of the investors. One of the core responsibilities of the asset manager is the design and the offer of tailor-made funds in terms of specific investment strategies and investor groups/categories. However, most of retail investment funds are distributed by intermediaries. It is the core responsibility of the intermediaries and the distribution channels to assure that a fund is sold to the ‘proper’ and corresponding investors. It is the responsibility of the intermediaries that the design and the investment strategy of the fund ‘fits’ to the target market.

Moreover, in any case, we request IOSCO to delete the following paragraph of the new drafted guidance under Recommendation 13:

> *‘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 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.’*

Such a detailed knowledge on the investor base is only required under the European Money Market Regulation[10] (MMFR) with an Article about the so-called ‘know your customer’ principle. We strongly disagree to extend these requirements, which are designed for money market funds with special liquidity risk profiles, to all open-ended investment funds.

Q 11: *Are there procedures or practices that responsible entities currently use to implement their stress tests which have been found to be particularly informative to responsible entities and which are not consistent with or included in the approach set out here? If so, please provide examples.*
Q 12: *Are there procedures or practices that responsible entities have not found to be particularly useful which the proposed approach to liquidity stress testing would encourage and why?*
Q 13: *Is the proposed approach to the design and operation of stress testing processes realistic and does it deal with the key issues?*
Q 14: *Does the proposed additional guidance under Recommendations 3, 7 and 12 add effectively to the available guidance?*
Q 15: *Does Recommendation 14 capture the best of current good practices in stress testing?*

In general, it must be noted that the FSB only states under its Recommendation 6 that authorities should require and/or provide guidance on stress testing at the level of individual open-ended funds to support liquidity risk management to enhance finance stability. The requirements and/or guidance should address the need for stress testing and how it could be done. In view of this recommendation, IOSCO is requested to consider proportionality from a financial stability perspective, such that stress testing requirements may vary depending on the relative size of individual funds, their investment strategies, and particular asset class holdings, and finally the role of authorities. The FSB only recommends that authorities should consider the objective of fund-level stress testing, governance of testing arrangements (e.g. who oversees the stress testing), frequency of stress tests and related reporting obligation. **In view of these items, we kindly ask IOSCO to review its drafted proposal fundamentally and to set standards on a more principle-based approach which is limited to these items. All other examples of good practices should be explained in IOSCO’s report of good practices with the clarification that these are only examples and not binding for the whole industry.** This would also allow the competent authorities to set stress testing guidance considering the specific local market conditions or other regulatory considerations and priorities.

The principle of portfolio management is to act in the best interest of the investors. In doing so, asset managers need a high degree of freedom to take autonomous decisions, abroad range of liquidity

[10] Regulation (EU) 2017/1131 of the European Parliament and of the Council of 14 June 2017 on money market funds, available at: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32017R1131&from=EN.

management tools and the freedom to use them flexibly but purposefully. That includes a high level of flexibility to make use of the funds' specific universe of financial instruments. In addition, we would like to highlight that liquidity stress tests designed for special types of open-ended investment funds (such as equity funds) could be inadequate for other types of investment funds (such as bond funds or open-ended funds which also invest in illiquid assets).

Moreover, within the European Union and Germany, asset managers are already required to perform strict liquidity management including liquidity stress tests for each individual fund.[11] These requirements are sufficient, suitable and reasonable. Those requirements are incorporated in liquidity based stress tests and represent an integral part of the internal risk control system. Against that background we appreciate not having implemented equal stress tests and scenarios across the whole asset management industry. That will be important to reduce the potential herding behaviour across the whole industry in a stressed situation by relying on the same stress test outputs (thereby increasing systemic risks). As such we value less but meaningful stress tests and we raise the question on the added value of hypothetical stress tests. Even more importantly, however, there is the need at least to agree on global non-bank data reporting and exchange standards with the industry to enable better regulation and supervision. In particular, removal of regulatory provisions which hinder the efficient functioning of the capital markets should be considered an overarching priority. Therefore, we propose a single regulatory reporting mechanism which would reduce operational effort and burden for asset managers as well as supervisory authorities, and which would nicely meet the G20 aim of improving data collection and exchange. For this purpose it is necessary that IOSCO defines on a global level which kind of data and in which frequency national competent authorities should collect data about liquidity risks. This important task should not be left solely to national authorities. For a common and global understanding of systemic risks and in avoiding burden for cross border activities of asset managers, it is important that all managers of funds report such data in a uniform way and all supervisory authorities have a uniform understanding. With better data exchange cross border intervention by several regulators needing to act together can be better tailored to individual situations and markets.

V. New Recommendation: Contingency Planning Recommendations

Q 16: *Does the recommendation add up to an effective testing procedure which will lead to the smooth triggering of applicable liquidity management tools when appropriate?*

We have only one comment on the explanation text under the proposed new Recommendation 16 and request IOSCO to amend subparagraph 2 letter f) as follows:

> *"f) there are policies in place as to* ***~~when~~*** ***<u>under which circumstances (including governance and decision process)</u>*** *the tools will be actively considered and that these policies are documented,* ***~~clear,~~*** *accessible to relevant 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~~****;"*

[11] Cf. Article. 48 and 49 of the Delegated Regulation (EU) No 231/2013 with regard to AIFM. In addition, Box 10 of CESR's Risk management principles for UCITS (CESR/09-178) of February 2009 (available under: https://www.esma.europa.eu/sites/default/files/library/2015/11/09_178.pdf) also requires the UCITS management company to provide a system of risk limits to monitor and control the relevant risks (including liquidity risks) for each managed UCITS, as approved by the Board of Directors and found to be consistent with the risk profile of the fund; Box 7 and the relevant explanations under paragraphs 41-43 require the UCITS management company to perform stress tests. The Germen legislator requires the same approach of liquidity management for UCITS managers.

We recommend not to stipulate in the policies ‘when’ the tools will be considered. The reason for this is to avoid the risk that the manager cannot activate the liquidity management tools as the prerequisites are not completely fulfilled. For the same reason we prefer not to make the policy overly detailed. We are worried that too detailed rules are counterproductive and not in the best interest of investors. Moreover, as far as the predefined policies are known by investors (for example institutional investors), we see the danger that investors could take advantage of arbitrage. However, in limited cases (such as investment funds with retail investors), it could be appropriate to define a contingency plan. In such cases, it is sufficient to determine the steps to be taken in a liquidity shortage (such as communication and decision making processes). As far as the policies are well documented, we assume that the decision maker will understand their content. Therefore we recommend a more general approach.

Q 17: *Other than those examples listed above, are there any additional scope and/or aspect that you consider necessary and appropriate to be included as part of the contingency plan for an effective implementation of liquidity management tools by CIS/responsible entities?*

No.

Q 18: *How do existing CIS envision transitioning to Recommendation 17?*

We propose to amend Recommendation 17 as follows:

> *‘The responsible entity should ~~**consider the implementation of additional**~~ **identify the types of circumstances where** liquidity management tools **may be used** to the extent allowed by local law and tion, ~~**in order to**~~ ~~**protect investors from**~~ **taking into account the** ~~un~~fair treatment **of all fund tors**, **in order to,** amongst other things, ~~or~~ prevent the CIS from diverging significantly from its investment strategy. **The responsible entity may use such tools only in these circumstances and if appropriate disclosure has to be made in accordance with Recommendation 7.’***

It must be noted that the FSB highlights under its Recommendation 8 that asset managers have the primary responsibility to exercise exceptional liquidity risk management tools regarding the open-ended funds they manage. The FSB states that the decision to use such tools should generally remain with the asset manager because the manager is responsible for evaluating what is appropriate for a particular fund, in light of its investment strategies, the liquidity of its portfolio, current market conditions, and other relevant circumstances. **In every case, it is at the discretion of the manager of the funds which tool they want to use because of very different fund types and structures. Therefore, we request IOSCO to clarify this important approach under Recommendation 17.**

In this context, we propose that the responsible entity may decide whether or not existing CIS shall transition to Recommendation 17. This will also depend on the requirements of local law and regulation.

We also propose a better wording with regard to the fair treatment of fund investors which is based on the wording under the AIFMD.