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IOSCO Issues Two Final Reports on Fund Liquidity Risk Management

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Investment Company Directors
ICI Global Members SUBJECTS: Compliance
Disclosure
Exchange-Traded Funds (ETFs)
Fund Governance
International/Global
Investment Advisers
Portfolio Oversight
Risk Oversight
Systemic Risk RE: IOSCO Issues Two Final Reports on Fund Liquidity Risk Management

The International Organization of Securities Commissions (IOSCO) published two final reports on fund liquidity risk management last week, the first titled *Recommendations forLiquidity Risk Management for Collective Investment Schemes* (the "Recommendations Report")[1] and the second titled *Open-ended Fund Liquidity and Risk Management—Good Practices and Issues for Consideration* (the "Good Practices Report").[2] These Reports follow the consultations that IOSCO issued in July 2017, on which ICI Global submitted comments.[3] After providing background information, this memorandum briefly summarizes the Reports.

Background

IOSCO published *Principles of Liquidity Risk Management for Collective Investment Schemes* in 2013 (the "2013 Liquidity Report").[4] The 2013 Liquidity Report was intended to be a practical guide on liquidity risk management of open-end funds for authorities and industry practitioners. Since then, regulatory bodies worldwide—including the U.S. Securities and Exchange Commission—have continued focusing on fund liquidity risk management. In 2017, the Financial Stability Board (FSB) issued *Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities*.[5] Nine of the FSB's final recommendations related to what the FSB termed "liquidity mismatch" in funds, and eight of those recommendations required IOSCO to take further action (in most cases, the FSB instructed IOSCO to "review its existing guidance and, as appropriate, enhance it").

Summary of the Recommendations Report

The Recommendations Report reaffirms and builds upon—and replaces—the framework of the 2013 Liquidity Report.[6] IOSCO also describes the Recommendations Report as the "final step"[7] in response to the FSB's liquidity recommendations. IOSCO's expectation is that securities regulators "will actively promote the implementation by responsible entities"[8] of the Recommendations Report. But IOSCO also states that "when the recommendations are being implemented, they have to be transposed within the context of the specific legal structures prevailing in each jurisdiction" and that "implementation of the recommendations may vary from jurisdiction-to-jurisdiction, depending on local conditions and circumstances." The Report also emphasizes that "there is no 'one size fits-all' solution and responsible entities are expected to exercise their sound professional judgement in the best interest of investors."

IOSCO's 17 Recommendations cover the fund design process (including achieving alignment between portfolio assets and redemption terms, and disclosure to investors); day-to-day liquidity management (including performance and maintenance of the liquidity risk management process, liquidity assessments of portfolio assets, and fund-level stress testing); and contingency planning (including availability and effectiveness of liquidity risk management tools). In comparison to the 2013 Liquidity Report, the Recommendations Report is notable in that it:

- Recasts the "Principles" as "Recommendations;"
- Provides additional guidance under Recommendation 3, which relates to determining a suitable dealing (*i.e.*, subscription and redemption) frequency for a fund, and the importance of this as a design decision;
- Substantially revises Recommendation 4 and its related guidance, which relates to the appropriateness of a fund's dealing arrangements for its investment strategy and portfolio assets, throughout the fund's lifecycle;
- Provides additional guidance under Recommendation 7, which relates to liquidity-related disclosure to investors;
- Provides additional guidance under Recommendation 12, which relates to identifying emerging liquidity shortages and maintaining the fund's investment strategy during stressed conditions;
- Provides additional guidance under Recommendation 13, which relates to incorporating relevant data and factors into the fund's liquidity risk management process and understanding the fund's investor base;
- Substantially revises Recommendation 14, which relates to conducting liquidity assessments in different scenarios, and provides lengthier and more specific guidance about fund-level stress testing as a means of doing so;
- Introduces new Recommendation 16, which relates to periodic operational testing of liquidity management tools to ensure readiness when necessary; and
- Introduces new Recommendation 17, which relates to the availability and use of additional liquidity management tools to protect investors from unfair treatment.

In finalizing the Recommendations Report, IOSCO made only modest changes to the 2017 consultation's proposed recommendations and related guidance.[9] The consultation discussed the unique liquidity characteristics of ETFs, and asked whether they should be subject to different liquidity requirements. The Recommendations Report opts against creating separate recommendations and guidance for ETFs, and instead states that the Report applies to ETFs. The Recommendations Report also contains a new sub-section addressing securities markets regulators' engagement with funds.

Summary of the Good Practices Report

IOSCO's Good Practices Report is meant to be read in conjunction with its Recommendations Report. It "outlines a number of practices among regulators and asset managers" and "provides practical information containing a series of examples and good practices." Further, "[t]he different scenarios and examples presented within are illustrative of the diversity of approaches by regulators and responsible entities alike." As with the Recommendations Report, IOSCO's changes to the 2017 consultation are relatively modest.

The Good Practices Report emphasizes the need for funds to ensure consistency between their redemption terms and their investment strategies. It provides guidance about what funds could consider at the design phase, and after they commence operations. It then covers the liquidity risk management tools available to funds, depending on the jurisdiction.[10] Specifically, it discusses swing pricing, anti-dilution levies, valuation practices (*i.e.*, switching valuation of funds' securities to "bid" or "ask" from market mid-prices, depending on fund flows), redemption gates, side pockets, notice periods, suspensions of redemptions, and in-kind redemptions. In each case, the Report describes the tool, sets forth advantages and disadvantages to its use, provides examples and/or short case studies, and highlights how certain jurisdictions regulate its use. The Good Practices Report concludes by discussing fund-level stress testing, providing background and highlighting current industry and regulatory approaches to its use as a component of the liquidity risk management process.

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endnotes

[1] Available at: www.iosco.org/library/pubdocs/pdf/IOSCOPD590.pdf. The Recommendations Report applies to open-ended collective investment schemes (*i.e.*, a "registered/authorised/public CIS which provides redemption rights to its investors from its assets, based on the net asset value of the CIS, on a regular periodic basis during its lifetime - in many cases on a daily basis, although this can be less frequently"). For simplicity, this memorandum refers to such CIS as "funds."

[2] Available at: www.iosco.org/library/pubdocs/pdf/IOSCOPD591.pdf.

[3] *See* Institute Memorandum No. 30780, dated July 14, 2017, for a detailed summary of the consultations. *See* Institute Memorandum No. 30875, dated September 18, 2017, for a summary of and link to ICI Global's comment letter.

[4] Available at: www.iosco.org/library/pubdocs/pdf/IOSCOPD405.pdf.

[5] Available at:

www.fsb.org/wp-content/uploads/FSB-Policy-Recommendations-on-Asset-Management-Structural-Vulnerabilities.pdf. *See* Institute Memorandum No. 30531, dated January 23, 2017, for a summary of the FSB's final recommendations.

[6] Pursuant to IOSCO's "Taxonomy" developed in 2014, "the term Principle [is] reserved for the current 38 Principles, as amended or added from time to time. IOSCO reports or their contents are further categorized as Standards, Recommendations, Good or Sound Practices or Survey Responses." Furthermore, "IOSCO does not have legal authority to enforce its standards or recommendations and jurisdictions are not legally bound by such international standards. However, the *standards* are developed following exhaustive due process keeping in mind the global public good. Given the global nature of markets, it is important to avoid regulatory arbitrage and to converge implementation of *standards* that are developed consensually to the maximum extent possible. The expectation, therefore, is for IOSCO *standards*, wherever possible, to be applied in all member jurisdictions." (emphasis added) *See IOSCO Processes for Policy Development and Implementation Monitoring*, available at
www.iosco.org/about/pdf/IOSCO-Policy-and-Implementation-Monitoring-Processes.pdf.

[7] Notwithstanding this characterization, the Recommendations Report states, "Following the adoption of the recommendations and once a period of time for initial implementation has passed (*e.g*. 2-3 years), IOSCO intends to assess implementation across the relevant jurisdictions."

[8] IOSCO uses the term "responsible entity" to mean the entity or the entities responsible for the overall operation of the fund and its compliance with the legal/regulatory framework in its respective jurisdiction (*e.g*., an investment adviser and/or fund board).

[9] Compared to the 2017 consultation, IOSCO (i) provides guidance under Recommendation 7 that is somewhat less detailed and broad in scope, and (ii) slightly reduces the scope of the fund-level stress testing guidance under Recommendation 14.

[10] IOSCO previously addressed this topic in 2015. *See Liquidity Management Tools in Collective Investment Schemes: Results from an IOSCO Committee 5 survey to members,* available at: www.iosco.org/library/pubdocs/pdf/IOSCOPD517.pdf.

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