Principles of Liquidity Risk Management for Collective Investment Schemes

Consultation Report

TECHNICAL COMMITTEE

OF THE

INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS

CR06/12 **26 APRIL 2012**

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Foreword

The International Organization of Securities Commissions' (IOSCO) Technical Committee (TC) has published this Consultation Report with the aim of outlining principles against which both the industry and regulators can assess the quality of regulation and industry practices concerning liquidity risk management for collective investment vehicles. Generally, these principles aim to reflect a level of common approach and to be a practical guide for regulators and industry practitioners. The principles are addressed to the entity/entities responsible for the overall operation of the CIS, and their implementation may vary from jurisdiction to jurisdiction, depending on local conditions and circumstances.

How to Submit Comments

Comments may be submitted by one of the three following methods **on or before Thursday 2 August 2012**. To help us process and review your comments more efficiently, please use only one method.

Important: All comments will be made available publicly, unless anonymity is specifically requested. Comments will be converted to PDF format and posted on the IOSCO website. Personal identifying information will not be edited from submissions.

1. **Email**

- Send comments to **cisliquidity@iosco.org**.
- The subject line of your message must indicate *Principles of Liquidity Risk Management for Collective Investment Schemes*
- If you attach a document, indicate the software used (e.g., WordPerfect, Microsoft WORD, ASCII text, etc) to create the attachment.
- Do not submit attachments as HTML, PDF, GIFG, TIFF, PIF, ZIP or EXE files.

2. **Facsimile Transmission**

- Send by facsimile transmission using the following fax number: + 34 (91) 555 93 68.

3. **Paper**

- Send 3 copies of your paper comment letter to:

Mohamed Ben Salem
International Organization of Securities Commissions (IOSCO)
Calle Oquendo 12
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Spain

Your comment letter should indicate prominently that it is a public comment on *Principles of Liquidity Risk Management for Collective Investment Schemes*

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Chapter 1: Executive Summary

Investors place money in collective investment schemes (CIS) with a view to gaining income, to preserve or to grow their capital, or a combination of these objectives. They also expect to be able to access their investments in accordance with the terms and conditions of the particular CIS they have invested in –often on a daily basis. As a general matter, the right to redeem units/shares is a defining characteristic of open-ended CIS. Good liquidity risk management is therefore a key feature of the correct operation of a CIS.

The topic of liquidity has been a key concern in the current global process of regulatory reform, although discussions have tended to focus on the importance of liquidity in banking, rather than other sectors.

Why are liquidity issues different in the CIS universe?

In the context of liquidity, CIS differ fundamentally from banks in that "maturity transformation"[1] is not an inherent feature of their operation, and the majority of CIS do not engage in such transformation to the extent that banks do. For example, many CIS use investors' subscriptions to invest in highly liquid large capitalisation listed company shares, which can quickly be sold if necessary to provide liquidity for meeting redemption requests from investors in the CIS. Neither do the majority of CIS provide any "promise" or guarantee that the investor will get back (at least) the same amount of money as they initially invest. An investor in a CIS is a shareholder; as opposed to a depositor in a bank, who is a creditor.

Liquidity crises are therefore less likely to cause systemic confidence problems in CIS than in banking. Nevertheless, a CIS may experience liquidity problems. Liquidity risk management in CIS is a complex area: poor liquidity can arise from many different sources, some of which are outside the control of the entity operating the CIS[2].

Liquidity risk management in CIS is directly linked to other aspects of CIS operation – in particular valuation. Although valuation is not addressed in detail in this paper, effective liquidity risk management requires effective and robust valuation arrangements[3].

In exceptional circumstances, a liquidity problem could lead to a CIS temporarily suspending all investor redemptions. IOSCO recently published "Principles on Suspensions of Redemptions in Collective Investment Schemes"[4].

Because of the importance of proper liquidity risk management, IOSCO is now issuing this consultation on principles of liquidity risk management for CIS. This consultation was

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1 At its simplest, using short-term liabilities to invest in long-term assets.

2 For example, if a market in which the CIS is invested closes unexpectedly.

3 IOSCO is consulting separately on *Principles for the valuation of Collective Investment Schemes, Consultation Report, Report of the Technical Committee of IOSCO* February 2012, available at www.iosco.org/library/pubdocs/pdf/IOSCOPD370.pdf.

4 *Principles on Suspensions of Redemptions in Collective Investment* Schemes, Report of the Technical Committee of IOSCO, January 2012, available at www.iosco.org/library/pubdocs/pdf/IOSCOPD367.pdf.

prepared by IOSCO's Investment Management Standing Committee. A number of market participants from different jurisdictions were consulted during its preparation, although the views expressed within this consultation are not necessarily shared by those firms.

Chapter 2: Introduction to the Principles

As set out in IOSCO's *Principles on Suspensions of Redemptions in Collective Investment Schemes*, the fundamental requirement of liquidity risk management is to "…*ensure that the degree of liquidity of the open-ended CIS [the responsible entity] manages allows it in general to meet redemption obligations and other liabilities.*"

The principles in this document set out more detail on how compliance with this requirement can be achieved. They relate to the three main stages of any relevant process: its establishment; performance/implementation and maintenance; and ongoing review (of its effectiveness).

The principles are structured according to the time frame of a CIS's life. They start with principles which should be considered in the design (pre-launch) phase of a CIS[5]. They then outline the principles that should form part of the day-to-day liquidity risk management process.

Application of the principles

The aim of this consultation is to outline principles against which both the industry and regulators can assess the quality of regulation and industry practices concerning liquidity risk management. Generally, these principles aim to reflect a level of common approach and to be a practical guide for regulators and industry practitioners.

The principles are addressed to the entity/entities responsible for the overall operation of the CIS and in particular its compliance with the legal/regulatory framework in the respective jurisdiction and thus for the implementation of the principles (referred to as "the responsible entity" in this consultation). The delegation of activities may not be used to circumvent the principles.

Although addressed to the responsible entity, the principles do not provide directly applicable standards to firms. When the principles are being implemented, they have to be transposed within the context of the specific legal structures prevailing in each jurisdiction (for example, some jurisdictions set out in their law quantitative limits on investments by CIS for liquidity purposes). Hence the implementation of the principles may vary from jurisdiction to jurisdiction, depending on local conditions and circumstances[6].

As noted above, liquidity risk management is a particular concern for "open-ended" CIS[7]. However, even for "closed-ended" CIS, some of the material in the principles is relevant (for example, such CIS may need to meet margin calls or other cash commitments to

5 Many of the considerations outlined in the pre-launch principles also remain relevant for ongoing liquidity management.

6 In several jurisdictions, regulators are unable to impose requirements directly on certain types of responsible entity/CIS (typically those which are not sold/marketed to retail investors). In those cases, these principles could be considered as 'best practices' for the entities responsible for operating those CIS.

7 Broadly, this means a 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.

counterparties on a timely basis). Responsible entities for closed-ended CIS should consider which principles are relevant to them.

Chapter 3: Pre-launch Liquidity Risk Management Principles

Principle 1
The responsible entity should draw up an effective liquidity risk management process, compliant with local jurisdictional liquidity requirements

The liquidity risk management process, and its operation, is the fundamental basis of liquidity control within the CIS. The remainder of the principles in this section expand on some of the factors that must be taken into account as part of this process.

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

When considering creating a new CIS, the responsible entity must be able to (demonstrate that they can) comply with the relevant explicit or principle-based local liquidity requirements that will apply to the CIS[8].

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

The responsible entity should fully consider the liquidity of the types of instruments in which the CIS’s assets will be invested and should ensure that these are consistent with the CIS’s ability to comply with its redemption obligations or other liabilities.

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

Principle 2
The responsible entity should set appropriate liquidity limits which are proportionate to the redemption obligations and liabilities of the CIS

The responsible entity should set appropriate internal definitions and limits for the CIS’s liquidity, which are in line with the principle of fair treatment of investors and the CIS’s investment strategy.

[8] The remainder of the principles in this document should be interpreted in that context. For example, in the case where a certain percentage of the CIS’s assets must be kept in a certain type of liquid instruments, the responsible entity’s systems should be appropriate to ensure that percentage is adhered to at all times.

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

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

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

Principle 3

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

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

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

Principle 4

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

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

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

Examples of tools which may be permissible in certain jurisdictions would include: exit charges, limited redemption restrictions, (investor level) gates, dilution levies, *in specie* transfers[9], lock-up periods, side letters which limit redemption rights or notice periods. Some of these tools (e.g. notice periods) may be built-in to the CIS's dealing policy, but others may be contingent (e.g. a limit to redemptions met the same day only if redemption requests exceed a certain percentage of the NAV).

Exceptional measures include side pockets[10] or suspensions. CIS's should not be managed in such a way that the investment strategy relies on the availability of these measures, should liquidity problems be experienced.

Principle 5
The responsible entity should consider liquidity aspects related to its proposed distribution channels

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

In some jurisdictions, it is common for investors to hold their investments through aggregated nominee accounts, making it more difficult for the responsible entity to fully understand the size and breakdown of individual unit-holders. In this situation a responsible entity should take all reasonable steps to obtain investor concentration information from nominees to assist its liquidity management.

Principle 6
The responsible entity should ensure that it will have access to, or can effectively estimate, relevant information for liquidity management

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

Principle 7
The responsible entity should ensure that liquidity risk and its liquidity risk management process are effectively disclosed to prospective investors

It is expected that a CIS's offering documents[11] would include an explanation of liquidity risk, why and in what circumstances it might arise and its significance and potential impact on the CIS and its unit-holders, as well as an appropriate summary of the process by which

[9] Retail investors should generally not be required to accept *in specie* transfers when they wish to redeem part or all of their investments.
[10] In some jurisdictions, side pockets may be considered to be 'tools' rather than 'exceptional measures' for certain types of CIS.
[11] The term *offering documents* here refers to documents that are freely available to investors.

the responsible entity aims to mitigate the risk. For example, disclosure of what actions the responsible entity would take in the event of a liquidity problem or the breach of internally set limits would be useful information. However, lengthy legal disclaimers or overly granular disclosure which would be confusing to investors should be avoided. In some jurisdictions large unit-holder concentration risk may have to be disclosed.

Explanation of any tools or exceptional measures that could affect redemption rights (see principle 4 above) should be included in the CIS's disclosure. The explanation should include what the tool or measure is, what effect its use will have on CIS liquidity/investor redemption rights and examples of when the tool might be applied (if it is of a contingent nature). A responsible entity must take care to ensure that these descriptions are clear and comprehensible to investors.

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

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

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

Principle 8
The responsible entity should effectively perform and maintain its liquidity risk management process

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

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

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

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

Principle 9
The responsible entity's liquidity risk management process must be supported by strong and effective governance

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

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

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

There should be an appropriate degree of independent oversight involved in reviews of the liquidity risk management process[12].

Principle 10
The responsible entity should regularly assess the liquidity of the assets held in the portfolio

The liquidity risk management process should enable the responsible entity to continuously measure, monitor and manage the CIS's liquidity. The responsible entity should take into account the interconnection of liquidity risk with other risk factors such as market risk or reputational risk[13].

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

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

Principle 11
The responsible entity should integrate liquidity management in investment decisions

The responsible entity should consider the liquidity of the types of instruments it intends to purchase or to which the CIS could be exposed[14] before transacting, and the impact that the transaction will have on the overall liquidity of the CIS during the lifetime of the investment. Responsible entities should only invest in assets if the investment does not compromise the ability of the CIS to comply with its redemption obligations or other liabilities.

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

For OTC securities other information may be more meaningful in delivering comparable analysis, such as the quantity and quality of secondary market activity, buy/sell spreads and the sensitivities of the price and spreads. The assessment of liquidity risk by asset type should also consider any fiscal constraints (for example, where asset sales would trigger a large tax liability which in effect reduces their liquidity).

[12] This does not mean the responsible entity necessarily has to involve an external party in the review.
[13] It is accepted that some risk factors are difficult or impossible to specify quantitatively.
[14] For some derivatives the settlement asset could be less liquid than the derivative, so this should also be considered.

Liquidity risk management must also consider collateral arrangements (for example, to take account of the risk of deterioration in the quality of collateral received from a counterparty in a derivative transaction, if it were to become illiquid). The liquidity “quality” of securities accepted as collateral should be evaluated on an ongoing basis, in light of collateral arrangements actually in place (for example, segregation of collateral accounts, unavailability of collateral for investment purposes, haircut thresholds and so on).

The responsible entity should take exceptional care if utilizing tools such as temporary borrowing to manage liquidity. Not only will the CIS incur a financial cost for this, but if the temporary borrowing does not solve the problem then the CIS may need to suspend or wind-up and it will at this point be leveraged, potentially with exacerbated problems. Investors in the CIS that benefit from the borrowing (by being able to redeem) may not be the ones paying the costs of it (remaining unit-holders). However, there may be some cases where inflows can be predicted with some certainty (e.g. if there are substantial regular monthly contributions into the CIS), which mitigate the risks involved with temporary borrowing.

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

Principle 12

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

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

Retail investors, in particular, will have a general expectation that, in normal circumstances, the CIS will be able to meet redemption requests on the standard terms set out in its offering documents. While the use of tools or exceptional measures which could affect redemption rights may enable a liquidity issue to be “managed”, by in some way restricting investor redemption rights, it is preferable to avoid this if possible (see principle 4 above). Where a responsible entity has a choice as to whether to apply a tool or exceptional measure that could affect redemption rights at all, or which of several tools or measures to apply, it must make this decision in the best interests of unit-holders.

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

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

Principle 13

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

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

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

Ideally, responsible entities should have some degree of knowledge of the CIS's investor base, and where possible should interact with relevant intermediaries to secure pre-notification about removal from a *best-buy* list or similar.

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

Principle 14

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

As part of the implementation of the liquidity risk management process, appropriate assessments should be carried out by the responsible entity of the liquidity risk to the CIS in normal and stressed scenarios (for example, atypical redemption requests).

For example, the responsible entity could analyze the number of days that it would take to sell assets and meet liabilities in the stressed scenarios simulated. In respect of collateral an assessment could be used to demonstrate that the quantity of liquid assets is sufficient to meet settlement of margin calls on derivatives positions.

Assessments should be based on reliable and up-to-date information, and the results should be taken into account in performing and maintaining the liquidity risk management process. Feedback from any real situations experienced should be used to improve the quality of output from future assessments.

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

Assessments should be carried out at a frequency relevant to the specific CIS.

Principle 15
The responsible entity should ensure appropriate records are kept, and relevant disclosures made, relating to the performance of its liquidity risk management process

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

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

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

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

Questions: **Do you have any comments on any of the principles?**
Are there any other principles that should be included?

Have you any other comments on the subject of liquidity risk management?

Annex A – list of market participants consulted

Francesco Betti – General Director, Aletti Gestielle SGR

Emmanuel Courant – Executive Board member, Edmond de Rothschild Investment Managers

Jose Carlos H. Doherty – ANBIMA

Lynn Hunter – Head of Business Development, Compliance, M & G

Andre Jäger - Head of Risk Management of the Universal Investment GmbH

Sean Krieger – Director, Compliance, Babson Capital Management

Amitabh Mohanty – Head of Fixed Income, Reliance Capital Asset Management Limited

Andre Monteiro – Partner & Chief Risk Officer, Gávea Investimentos

David Pollok - General Counsel, Lighthouse Investment Partners LLC

Frederic Sadaca – Head of Risk Management, Edmond de Rothschild Investment Managers

Jeremy Soutter – Global Head of Products, AVIVA