Principles of Liquidity Risk Management for Collective Investment Schemes

Final Report

BOARD OF THE

INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS

FR03/13 **MARCH 2013**

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Foreword

The International Organization of Securities Commissions' (IOSCO) Board has published this Final Report, which contains 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.

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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.

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 capitalization listed company shares, which can quickly be sold if necessary to provide liquidity for meeting redemption requests from investors in the CIS. Neither does the majority of CIS provide any "promise" or guarantee that investors will get back (at least) the same amount of money as they initially invested. 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 has published *Principles on Suspensions of Redemptions in Collective Investment Schemes*.[4]

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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 has consulted separately on *Principles for the Valuation of Collective Investment Schemes,* Consultation Report, Report of the Board of IOSCO, February 2012, available at www.iosco.org/library/pubdocs/pdf/IOSCOPD370.pdf.

4 *Principles on Suspensions of Redemptions in Collective Investment* Schemes, Final Report, Report of the Board of IOSCO, January 2012, available at

http://www.iosco.org/library/pubdocs/pdf/IOSCOPD367.pdf.

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 that 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.

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

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

6 In certain jurisdictions, regulators do not impose liquidity requirements directly on certain types of responsible entities or CIS (e.g., those which are not sold/marketed to retail investors). In those cases, these principles may be considered as 'best practices' for the entities responsible for operating those CIS, as appropriate under the facts and circumstances.

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.

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 expands on some of the factors that must be taken into account as part of this process. The liquidity risk management process forms one part of the broader total risk management process. Risk management generally relies on strong and effective governance.

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, at an appropriate level of granularity,[9] and should seek to ensure that, taking account of the CIS's portfolio as a whole, 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 and sufficiently bespoke for any other CIS it is used for.

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

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

9 Consideration at the level of the asset class may not be sufficiently granular - for example, some equities can be liquid and some illiquid.

The responsible entity should set appropriate internal definitions and thresholds for the CIS's liquidity, which are in line with the principle of fair treatment of investors and the CIS's investment strategy. The thresholds should act as a signal to the responsible entity to carry out more extensive in-depth, quantitative and/or qualitative liquidity analysis as part of the risk management process (with the intention that the responsible entity would then take appropriate remedial steps if the analysis revealed vulnerabilities).

For example, a daily dealing 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 thresholds 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.

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 in the CIS's constitutional documents the ability to use specific tools or exceptional measures which could affect redemption rights

Certain tools can be used as part of a CIS's "normal" operations, provided there is full disclosure (see principle 7 below), but their inclusion in the constitutional documents does not excuse the responsible entity from needing to consider the remainder of these principles for its liquidity risk management process to be effective.

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, gates, dilution levies, *in specie* transfers,[10] 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[11] 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 be fully aware of the make-up of the underlying investor base (for example, a holding of one million units in an aggregated account could represent a small number of investors each with large individual holdings, or many more investors each with a smaller number of units). In this situation a responsible entity should take all reasonable steps to obtain investor concentration information from nominees to assist its liquidity management (for example, via contractual arrangements).

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.

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10 Retail investors should generally not be required to accept *in specie* transfers when they wish to redeem part or all of their investments.

11 In some jurisdictions, side pockets may be considered to be 'tools' rather than 'exceptional measures' for certain types of CIS.

Principle 7

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

As part of the disclosures in a CIS's offering documents[12] about the risks involved in investing in the CIS, there should be a proportionate and appropriate explanation of liquidity risk. This should include an explanation of why and in what circumstances it might crystallize; its significance and potential impact on the CIS and its unit-holders, and a summary of the process by which the responsible entity aims to mitigate the risk. For example, disclosure of what actions the responsible entity would take in the event of a liquidity problem would be useful information. The explanation should set out clearly how the investor could be affected. 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 offering documents. 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 or measure 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 disclosed to investors.

[12] The term 'offering documents' here refers to documents that are freely available to investors.

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

Principle 8
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).

Again, related to the particular governance structure and size of the responsible entity, there should be an appropriate degree of independent oversight involved in reviews of the liquidity risk management process.[13]

Principle 9
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, delivery and payment obligations such as 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.

[13] This does not mean the responsible entity necessarily has to involve an external party in the review.

Regular periodic reviews of the effectiveness of the liquidity risk management process should be undertaken by the responsible entity and the process should be updated as appropriate. An additional review and possible updates may also be necessitated by the occurrence of certain events. For example, if the CIS is to invest in a new type of asset or if the investor profile has changed materially (from that anticipated) – for example, if a CIS originally expected to have a large number of retail investors but in fact only attracts a small number of institutional investors each owning a significant share of the CIS – the policy should be reviewed and updated, if deemed appropriate.

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 regularly 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.[14]

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 thresholds.

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,[15] as well as liquidity effects of the investment techniques/strategies it uses, before transacting;[16] and the impact that the transaction or techniques/strategies will have on the overall liquidity of the CIS. Responsible entities should only carry out transactions if the investment or technique/strategy employed 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,

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14 It is accepted that some risk factors are difficult or impossible to specify quantitatively.

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

16 Some investment strategies would preclude detailed analysis before every individual transaction, but application of the liquidity risk management process should provide reasonable assurance that the investment decisions are consistent with the CIS's overall liquidity profile.

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.

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). With respect to derivative transactions, the responsible entity should ensure that the quantity of liquid assets is sufficient to meet settlement of margin calls.

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 aim to assist the responsible entity in identifying liquidity pressures before they crystallize, 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 exceptional measures may enable a liquidity issue to be "managed", by 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 an exceptional measure – or a tool - 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.

Responsible entities should make best efforts to manage future cash flows so as to assist with liquidity management (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 seek to ensure that in all but exceptional circumstances the CIS can 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.[17]

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,[18] 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, taking account of the expected behavior of other market participants in the same conditions, and any actions the responsible entity would take (e,g., imposition of contingent liquidity management tools). 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.

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17 For example, the responsible entity may consider whether publicity about the relatively poor performance of a CIS compared to its peer group might lead to an increase in redemption requests and/or a decrease in new subscriptions.

18 Certain jurisdictions may permit investment funds to enter into different contractual arrangements with different investors.

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

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 one factor, as such a downgrade can 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 (see principle 4 above) 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).

Appendix I

Feedback Statement on the Public Comments received by IOSCO on the *Principles of Liquidity Risk Management for Collective Investment Schemes – Consultation Report*

Fifteen responses were received to the draft Principles of Liquidity Risk Management for Collective Investment Schemes, which were put out for public consultation between 26 April and 2 August 2012.

Non-confidential comments were received from the following organizations:

1) Association Française de la Gestion financière (AFG)
2) BlackRock
3) British Private Equity and Venture Capital Association (BVCA)
4) Bundesverband Investment und Asset Management e.V. (BVI)
5) Chris Barnard
6) Dubai Financial Services Authority (DFSA)
7) Egyptian Financial Supervisory Authority
8) European Fund and Asset Management Association (EFAMA)
9) Investment Company Institute
10) Investment Management Association (IMA)
11) Isle of Man Financial Supervision Commission
12) Maldives Capital Market Development Authority
13) Managed Funds Association (MFA)
14) Superintendencia de Compañías del Ecuador
15) Vereniging VEB NCVB (Dutch Investors' Association)

IOSCO took these comments into account in preparing the final report. This feedback statement summarizes the main issues raised in the responses received and notes where changes have been made to the report as a result. Several other minor changes have been made to improve the drafting of the final report.

General comments

In general, respondents welcomed IOSCO's work as providing an effective framework for liquidity management. Several respondents had no detailed comments to make. There was no overall theme to the remainder of the general comments.

EFAMA and the IMA argued that the principles should include management of inflows, and that regulators should be as flexible as possible. MFA argued that the principles were not fully appropriate for hedge funds and the BVCA argued for clarification of the application to closed-ended funds. The ICI explained how the principles were currently linked to US fund regulation. BlackRock stated that there should be a focus on overall portfolio liquidity. The Superintendencia de Compañías del Ecuador stated there should be a liquidity coverage ratio based on Basel III.

IOSCO response. IOSCO has taken account of several of these comments in the elaboration of the individual principles, but has not specified further detail on their application to closed-ended CIS (see Chapter 2) or mandated a specific liquidity coverage ratio. Although receipt of investor money affects CIS liquidity, IOSCO has decided not to directly address principles relating to the management of inflows in this report.

Principle 1

Several respondents (BlackRock, IMA, AFG, EFAMA) argued that the responsible entity could only "seek to ensure" an outcome, in line with IOSCO's comments that some factors could be outside a responsible entity's control. AFG, EFAMA and IMA noted that liquidity should be managed in the CIS's portfolio as a whole. AFG and EFAMA pointed out that "type of instrument" was not granular enough for proper liquidity management. BlackRock stated that liquidity risk management should be part of wider risk management.

IOSCO response. IOSCO has taken account of these comments in the revised explanatory text for the principle, and also added a reference to the importance of strong and effective governance.

Principle 2

Several respondents (BlackRock, IMA, EFAMA, AFG) argued that the principle should refer to "thresholds" rather than "limits", these acting as triggers for a more qualitative assessment to be made. Some respondents did not agree with using a money market fund as an example in the principle.

IOSCO response. IOSCO has taken account of these comments in the revised explanatory text for the principle.

Principle 3

IMA and EFAMA argued it could be appropriate to have a daily dealing fund invested in illiquid assets if appropriate liquidity management tools were in place. BVI mentioned that the principle should clarify the liquidity management procedures for fund-of-funds. The Dutch Investors' Association recommended amending the principle to reflect that there should be a suitable time period between transaction cut-off and settlement time, so that there could be orderly management of inflows and outflows. AFG requested clarity that the dealing frequency included the use of tools (e.g., notice periods).

IOSCO response. IOSCO has simplified the explanatory text for the principle and does not believe it is necessary to include specific wording related to these comments.

Principle 4

BlackRock, IMA and EFAMA noted that the wording of the first paragraph appeared inconsistent: liquidity management tools could be used as part of the liquidity risk management process – exceptional measures were separate. Dubai FSA asked for clarification over what was meant by “supervisory action” in the first paragraph. MFA stated that hedge funds used fund level gates and notice periods, and that side pockets were not an exceptional measure for hedge funds.

IOSCO response. IOSCO has taken account of these comments in the revised explanatory text for the principle. With respect to side pockets, this point was already addressed in a footnote. The order of words in the principle has been changed to make it clearer.

Principle 5

Blackrock, IMA and EFAMA argued that regulators should make intermediaries assist responsible entities. MFA and AFG noted the practical difficulties inherent in this principle. BVI noted that distribution issues were not necessarily part of liquidity risk management and EFAMA stated that the information is not relevant to managing the CIS in accordance with its investment objectives.

IOSCO response. IOSCO believes distribution aspects are relevant to liquidity management and so has maintained the principle as originally drafted. It may not be possible for regulators to impose requirements on nominees to disclose investor concentration information, but the explanatory text has been amended to include, as an example, responsible entities using contractual arrangements to obtain such information.

Principle 6

Several respondents (BlackRock, IMA, AFG, EFAMA) argued for “seek to ensure” wording to be used. BVI suggested that it might not be possible to get information on the underlying investments of funds-of-funds and that any partial non-transparency should be taken into account in the liquidity risk management process. Dubai FSA asked for further examples.

IOSCO response. IOSCO believes the ability to access (or effectively estimate) relevant information for liquidity management is essential and so has maintained the principle as originally drafted.

Principle 7

Respondents generally challenged the amount of information this principle might require, and that it would not add value to investors. EFAMA, BVI and AFG argued that some information was internal and should not be subject to disclosure. Dubai FSA argued that prospectus disclosure should be mandatory not “expected”.

IOSCO response. IOSCO has taken account of these comments in the revised explanatory text for the principle. The “quantity” of disclosure should be proportionate and appropriate.

(re-ordered) Principle 8

Dubai FSA suggested that the order of Principles 8 and 9 could be reversed so that material relating to governance came first. Blackrock, MFA and EFAMA asked for clarification of the meaning of “independent” oversight. Dubai FSA also recommended that there should be an approval process regarding risk tolerance for liquidity management.

IOSCO response. IOSCO has changed the order of principles 8 and 9, and has amended the explanatory text for the principle regarding proportionality. Footnote 13 is also relevant to the meaning of “independent” oversight.

(re-ordered) Principle 9

BVI and EFAMA recommended replacing “expected margin calls” with “delivery and payment obligations such as margin calls”. Dubai FSA noted that it could be mentioned who would be involved in reviews. MFA questioned why a change in the investor base required a change in policy, if redemption rights for the actual investors were the same.

IOSCO response. IOSCO has amended the explanatory text for the principle with respect to margin calls, but does not believe it is necessary to specify who may carry out reviews of the process. IOSCO believes that even where the legal redemption rights of different types of investors are the same, a change in investor base would necessitate a review of the process, as the behavior of different types of investors (e.g., retail vs. institutional) may differ.

Principle 10

Several respondents (BlackRock, IMA, AFG, EFAMA) recommended that the word “continuously” should be replaced with “regularly” in order to be consistent with the wording in the principle. IMA, AFG & EFAMA also suggested replacing “limits” with “thresholds”, consistent with their comments on Principle 2. BVI suggested that the commentary should mention that not all assets held in the portfolio must be liquid. Dubai FSA suggested mentioning examples of the areas of a responsible entity that should be involved in an assessment.

IOSCO response. IOSCO has amended the explanatory text for the principle with respect to the terms “continuously” and “limits”, but does not believe it is necessary to specify who may be involved in assessments. Principle 1 includes wording relating to liquidity being considered at the level of the whole portfolio.

Principle 11

IMA, EFAMA, AFG and Blackrock all argued that the material on collateral should be amended or removed, as it was separate from standard liquidity management. EFAMA and BVI argued for the deletion of the sentence referring to fiscal constraints. Blackrock, IMA, EFAMA and AFG argued that the wording expected too much from the responsible entity in terms of being able to predict the future. MFA argued that assessment could not be carried out before every single transaction.

IOSCO response. IOSCO has taken account of these comments in the revised explanatory text for the principle, but believes the material on collateral should be retained, as it is an aspect of liquidity management. References to investment techniques/strategies have been added to the explanatory text.

Principle 12

Consistent with their comments on Principle 4, several respondents argued that liquidity management tools should be considered a part of normal liquidity management. BVI, IMA, EFAMA, AFG and Blackrock argued that the underperforming fund example should be deleted. MFA argued that the responsible entity should manage cash flows rather than trying to ensure they were predictable – the latter could restrict investment options or distribution opportunities.

IOSCO response. IOSCO has taken account of these comments in the revised explanatory text for the principle, but considers the underperforming CIS example to be relevant (however the example has been re-worded and moved to a footnote under Principle 13).

Principle 13

IMA, EFAMA, AFG and Blackrock argued that some of this material was covered in earlier principles (e.g., Principle 1). MFA argued for amendment of the text because processes should be designed to achieve desired outcomes, they cannot ensure them. MFA also noted that to the extent permitted by law, individual negotiation with investors should be possible. EFAMA and BVI noted that it would be difficult for large firms to have dialogue with their investors; EFAMA, BVI and AFG noted that it is difficult to model scenarios based on investor behavior.

IOSCO response. IOSCO has taken account of these comments in the revised explanatory text for the principle, but believes it is important and possible for firms to take into account investor behavior in their liquidity management. Principle 1 is a "pre-launch" principle.

Principle 14

Dubai FSA noted the importance of back-testing. Chris Barnard argued that stress tests must consider the reaction of other market participants faced by the same scenario and should also take account of what actions the responsible entity might take ("use test"). EFAMA and the IMA restated their earlier views about inclusion of material on collateral. BVI argued that reliance on credit ratings should be reduced.

IOSCO response. IOSCO has taken account of these comments in the revised explanatory text for the principle, but in line with its response on principle 11 has not deleted the wording related to collateral.

Principle 15

IMA and EFAMA argued the disclosure requirements were too broad and were already subject to national requirements. EFAMA argued that the annual report was the wrong place for these disclosures. AFG and EFAMA mentioned the need for clarification of "exceptional measures".

IOSCO response. IOSCO has amended the explanatory text for the principle to link the use of "exceptional measures" back to principle 4, but does not agree that the disclosure requirements are too broad.

Appendix II

Public Comments received by IOSCO on the *Principles of Liquidity Risk Management for Collective Investment Schemes – Consultation Report*

1) Association Française de la Gestion financière (AFG)
2) Managed Funds Association (MFA)
3) Dubai Financial Services Authority (DFSA)
4) British Private Equity and Venture Capital Association (BVCA)
5) BlackRock
6) European Fund and Asset Management Association (EFAMA)
7) Bundesverband Investment und Asset Management e.V. (BVI)
8) Maldives Capital Market Development Authority
9) Beleggersvereniging VEB (Dutch investor's Association)
10) Financial Supervision Commission of the Isle of Man (FSC)
11) Chris Barnard
12) ICI (Investment Company Institute)
13) IMA (Investment Management Association)
14) International Banking Federation (IBFED)
15) Ecuador Liquidity Risk Management, Intendencia de Mercado de Valores