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Shane Worner
IOSCO General Secretariat
International Organization of Securities Commissions
Calle Oquendo 12
28006 Madrid, Spain

Re: Public Comment on Open-ended Fund Liquidity and Risk Management—Good Practices and Issues for Consideration

Dear Mr. Worner:

CFA Institute[1] is pleased to comment on IOSCO's consultation on open-ended fund liquidity and risk management—good practices and issues for consideration (Consultation), which is a companion piece to its consultation on CIS liquidity risk management guidelines. CFA Institute represents the views of those investment professionals who are its members before standard setters, regulatory authorities, and legislative bodies worldwide on issues that affect the practice of financial analysis and investment management, education and licensing requirements for investment professionals, and on issues that affect the efficiency, integrity and accountability of global financial markets.

Executive Summary

We support reasonable liquidity risk management policies and procedures for the smooth functioning of financial markets and for the safeguarding of investor interests. To that end, we welcome a balanced approach in reviewing the asset management industry, as an important segment of the entire financial system.

We agree that ensuring the fair treatment of investors should be a primary objective of liquidity management and support IOSCO's approach to providing guidance and best practices through this Consultation. Funds particularly bear a responsibility for including language in their documentation for alerting investors to the possible risk of liquidity management tools and the likelihood of their use. This provides information that better allows investors to make meaningful investment decisions.

[1] CFA Institute is a global, not-for-profit professional association of more than 151,900 investment analysts, advisers, portfolio managers, and other investment professionals in 145 countries, of more than 145,600 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 148 member societies in 73 countries and territories.

We do not unconditionally support stress testing of funds, as we recognize the potential for herding. We encourage careful review of the methods by which fund-level stress testing would be allowed.

Discussion

This Consultation provides a helpful overview of liquidity risk management practices used throughout the world's financial markets, as well as meaningful discussion on the pros and cons of the practices themselves. We appreciate IOSCO's work through its 2015 survey and subsequent roundtables to assimilate and present this diversity of approaches used to address this important issue.

CFA Institute strongly supports efforts to monitor areas throughout our financial markets that may create systemic risks for the financial system. As strong proponents of investor protections, we also are sensitive to practices within the financial markets that may disadvantage investors during times of extreme market stress. Thus, we believe good liquidity risk management policies and procedures are important for both the smooth functioning of the financial markets as well as for fund investors. We welcome a balanced approach in reviewing the asset management industry, including open-ended funds, as part of the larger financial system.

As noted in the Consultation, past incidences of large fund redemptions have *not* often triggered the need to use liquidity management tools, or "had a substantial impact on asset prices or the broader financial system." Because of this fact, we have questioned the heightened attention given by regulators to the liquidity management practices of the asset management industry as an area of potential systemic risk and have thought it to be misplaced.[2] In particular, we have questioned the need and appropriateness of additional regulations to mandate "risk contagion" efforts across much of the fund industry, particularly given the agency nature of the asset management industry and the existing regulations for open-end funds that serve to effectively mitigate against systemic risk connected to redemptions.

In this Consultation, IOSCO appears to shift the focus from systemic risk and contagion concerns to liquidity management practices in connection with the "possible mismatch between the redemption terms of a fund (in most cases daily redemption) and the liquidity of its underlying assets." The Consultation organizes this review into three main areas: ensuring consistency between a fund's redemption terms and its investment strategy; liquidity risk management tools; and fund-level stress testing.

[2] See, e.g., 12 January 2016 letter to Brent J. Fields of the SEC on "Open-End Fund Liquidity Risk Management Programs; Swing Pricing: Re-Opening of Comment Period for Investment Company Reporting Modernization Release" from Kurt N. Schacht and Linda L. Rittenhouse; and 21 September 2016 letter to Secretariat of the Financial Stability Board on "Consultative Document: Proposed Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities" from Kurt N. Schacht and Linda Rittenhouse.

We support meaningful procedures for safeguarding investor interests. As we noted in our response to the Financial Stability Board consultation on Proposed Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities, we believe that jurisdictions overseeing the majority of open-end funds already have requirements that address liquidity risk management practices on a daily basis and impose responsibilities on the fund manager (or its board of directors) to ensure that redemption requests can be met. But we welcome the review and enhanced guidance provided by IOSCO that address the various ways these different jurisdictions actively manage this possible mismatch as a way to highlight best practices in this area.

(a) Ensuring consistency between a fund's redemption terms and its investment strategy

How to maintain appropriate levels of liquidity is an important consideration for funds. Given the diversity of open-end funds, however, we believe proscribed sets of mandatory restrictions, classifications, or use of certain tools may be unrealistic. We also are concerned that imposing liquidity limits on funds may give investors a false sense of security when assessing the potential risks of those funds. Instead, investors need to continue their due diligence consideration of all risk factors to inform their decision making.

To that end, we welcome IOSCO's approach to provide guidance and best practices for liquidity management, while realizing that the process needs to be holistic—taking into account the nature of the fund, its asset composition and concentration, and investor base, among other things.

We agree with the Consultation that setting appropriate requirements and guidance to ensure the fair treatment of investors is a primary objective of liquidity management. From the outset, funds must consider their investment objectives with their portfolio compositions to balance liquidity and diversification needs, and the fair treatment of investors over the life of the fund. Investors deserve to know the risks associated with their investments in order to make meaningful investment decisions.

As noted in the Consultation, the U.S. Securities and Exchange Commission's (SEC) recent adoption of a rule mandating that open-end funds (other than money funds) adopt a liquidity risk management program specifically requires funds to consider liquidity risk factors, like investment strategies, when establishing a highly liquid investment minimum. This consideration now obligates funds to evaluate their liquidity needs in light of investment strategies and conditions, in the context of possible redemption obligations, among other things.

We also agree with the Consultation's suggestion that fund managers consider "if they might need to foresee specific redemptions…that would need to be specified in the fund's documentation." We strongly believe that funds must take responsibility for notifying investors of the risks of whatever liquidity management tools they plan to use, or even of the possibility of their use. Situations in the recent past remind us of times when funds may not have adopted procedures but nevertheless found themselves in a situation where unanticipated actions appeared to be the only viable option. In fairness to investors, funds must consider possible scenarios and ensure full transparency about how they will handle liquidity issues, including redemption requests and suspensions.

(b) Liquidity risk management tools

We agree with the Consultation's recognition that in general (and with the exception of some money market funds), public "open-ended funds have historically been able to manage their day-to-day liquidity requirements, even during periods of high redemption demand, in an orderly manner." Yet, we also have concerns about ensuring liquidity risk management tools are in place to offer investor protections that mitigate first-mover advantage should funds find themselves in situations of extreme stress.

We support an approach that allows open-end funds flexibility to use tools that are appropriate in light of their asset compositions, risk-taking policies, use of leverage, structure, and asset or industry concentrations, among other characteristics. To that end, we favor a principles-based approach with guidance that allows funds to conduct ongoing reviews and assessments based on the totality of fund attributes.

We agree that these liquidity risk management tools aimed at managing redemption rights should be used sparingly, on a temporary basis and only in exceptional circumstances. We also strongly agree that these tools must be used in the best interest of fund investors—those purchasing, selling, and remaining in the fund.

We also support the use of swing pricing not only in stressed conditions, but as a means of helping to discourage redemptions that are motivated by the first-mover advantage and as a way to help manage shareholder dilution. We agree that any swing pricing policy should be applied consistently and systematically, and believe that funds' boards of directors, including a majority of independent directors, should have to review and approve swing thresholds. This independent review is important to safeguard shareowner interests, given that swing pricing may create conflicts for the funds' advisers. As noted, the SEC recently adopted a rule allowing open-end funds (other than money funds and ETFs) to use swing pricing to help mitigate the dilution of share value for fund sharehowners.

We believe that when properly managed, redemption gates serve as an effective liquidity management tool, in times of extreme fund stress, and prefer optional swing pricing and the use of gates over the use of cash buffers. We also believe that suspending redemptions should be used only in the most extreme cases and even then, as a last resort and upon determination that there are no other viable options.

(c) Fund-level stress testing

Our concern with stress testing of funds centers on the potential for herding. The programs that are typically used to conduct stress testing may favor certain types of investment products, practices and redemption provisions. If required, use of standardized testing in the asset management industry could inadvertently encourage herding, which could increase the potential for systemic risk, as we have seen in the commercial banking industry. We thus suggest careful review of the requirements and methods by which fund-level stress testing will be tailored to consider the characteristics of the asset management industry and thus intended to avoid the unintended risk consequences related to systemic risk problems in the banking sector in the recent past.

Conclusion

We appreciate IOSCO's thorough review and discussion of liquidity risk management, supplemented by actual practices and regulatory requirements from many jurisdictions. Should you have any questions about our position, please do not hesitate to contact Kurt N. Schacht, CFA at kurt.schacht@cfainstitute.org, 212.756.7728 or Linda Rittenhouse at linda.rittenhouse@cfainstitute.org, 434.951.5333.

Sincerely,

/s/ Kurt N. Schacht

Kurt N. Schacht, CFA
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/s/ Linda L. Rittenhouse

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