sifma
asset management group

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RE: IOSCO Consultation Report, November 2024, "Revised Recommendations for Liquidity Risk Management for Collective Investment Schemes." (CR/06/2024)

1. **Are the identified common components of OEF's structure including notice periods, lock-up periods, settlement periods and redemption caps accurately described? Are there any relevant additional considerations when setting the notice periods, lock-up periods, settlement periods or redemption caps?**

Comments are provided jointly on behalf of The Securities Industry and Financial Markets Association ("SIFMA") and the Asset Management Group of SIFMA ("SIFMA AMG").

SIFMA AMG brings the asset management community together to provide views on U.S. and global policy and to create industry best practices. SIFMA AMG's members represent U.S. and global asset management firms that manage more than 50% of global AUM. The clients of SIFMA AMG member firms include, among others, tens of millions of individual investors, registered investment companies, endowments, public and private pension funds, UCITS and private funds such as hedge funds and private equity funds.

SIFMA is the leading trade association for broker-dealers, investment banks, and asset managers operating in the U.S. and global capital markets. On behalf of our members, SIFMA advocates for legislation, regulation, and business policy affecting retail and institutional investors, equity and fixed income markets, and related products and services. SFIMA serves as an industry coordinating body to promote fair and orderly markets, informed regulatory compliance, and efficient market operations and resiliency. SIFMA also provides a forum for industry policy and professional development. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association ("GFMA").

<u>Fund v. Market Liquidity</u>

As a threshold matter, liquidity management for an individual fund under ordinary market conditions is a different matter than liquidity management for a fund when the entire market is challenged. Fund-specific liquidity construction in ordinary market conditions is manageable with prudent management. Funds can take steps to mitigate liquidity risks if overall market liquidity changes. Market liquidity changes and the specifics of a particular significant market liquidity event, however, are difficult to predict. Both are important, but they have different fact patterns and available tools. The two are related but should not be conflated.

In the same way, the liquidity of individual instruments should not be conflated with overall fund liquidity and the ability to meet redemptions. The overall picture of fund liquidity is relevant to redemptions, not individual holdings viewed in isolation. Individual holdings and portfolio construction are important, but funds have different shareholder compositions with different behaviors and funds have different tools such as credit lines and interfund lending. As the IOSCO Consultation notes, notice periods and redemption terms can also be important mechanisms to help manage liquidity. In many cases, it is in the best interests of shareholders and fund returns for some portion of the fund's holdings to be in less liquid or even illiquid instruments. It is also important for issuers and the broader capital markets that funds be viable investors.

Pitfalls of liquidity criteria and liquidity thresholds

Proposed Guidance 1 focuses on determining asset liquidity. Investment and risk professionals managing a fund might conceptually think about liquidity assessment through a spectrum of liquidity. Having a vocabulary that references relative liquidity can be helpful. However, caution is advised before applying a system of prescriptive classification methodologies and mandated thresholds. Attempting to apply a one-size-fits-all approach will inevitably lead to debates about the appropriate thresholds and the methodologies used to drive the underlying classifications.

By way of illustration, the IOSCO Consultation's definition of "Less liquid" includes assets that, in stressed conditions, might not be readily convertible into cash without significant discounts and whose valuations might become more difficult to assess with certainty (emphasis added). Operationally, a fund would be challenged to develop and maintain objective means of assessing classifications based on predictions of what might occur in the future in unknown market conditions.

Given the ambiguous nature of the criteria and arbitrary nature of the thresholds, they would become hard and fast guidelines that govern investment decisions. Funds would execute trades with an eye on the thresholds that may not have been needed otherwise. The IOSCO Consultation rightly notes the risk of threshold/cliff edge effects that distort behavior around arbitrary thresholds.

Principles Rather than Prescriptions

As a general proposition, effective liquidity risk management cannot be reduced to a prescriptive formula expressed through regulatory mandates. Markets are inherently dynamic and the future is never certain. Funds have different investment strategies and approaches and different investor bases with different behaviors. Funds with their own investment and risk professionals have their own views and methodologies and tools to assess and manage risk. New ideas emerge and old ideas evolve. Different funds with the same tools and strategies may still employ those tools in different ways.

The IOSCO guidance references many aspects of liquidity risk management that are worthy of consideration and principles that funds strive to honor. Funds have their own commercial reasons to be thoughtful and prudent and make decisions that are in the best interests of fund shareholders. Attempting to impose prescriptive solutions can impede rather than promote effective fund liquidity risk management.

Three primary themes on Notice Periods, Lock-up Periods, Settlement Periods, Redemption Caps:

First, investors have a multitude of investing options. They are not limited to, nor compelled to invest only through open-end funds. They choose open-end funds for the unique features, including daily liquidity. This hallmark feature should be preserved and caution is warranted before imposing any measures that make it more difficult for investors to trade in and out of open-end funds. Open-end fund investment vehicles are a critical part of a vibrant capital market and should be encouraged rather than impaired.

Second, funds are not homogenous and therefore are in the best position to know their specific fund characteristics and make decisions about fund design. Even funds with similar strategies using similar asset classes make different investment decisions, take different approaches to manage risk, and have different shareholder compositions.

Such measures may be appropriate for a fund to consider at inception when designing its strategy, determining instruments for investment and associated guidelines/limits, and considering shareholder redemption frequency. Product design also considers fund distribution and flow behavior (including timing, velocity, and scale) and investor concentration. Investor behavior may may change during the life of a fund and future investor behavior will not be known with absolute certainty. Funds may have facilities such as lines of credit to help manage liquidity or provide more tools in times of unexpected flow activity. A fund's use of such measures may vary depending on market conditions. For example, notice periods for a private fund might be extended during stressed conditions if the fund manager thinks prudent to manage liquidity and outflows. Not all aspects of all tools must remain fixed throughout the life of a fund. For all these reasons, funds are best positioned to determine how to organize and manage their operations and features.

Third, some measures may not always be feasible given operational logistics or regulatory hurdles in a particular jurisdiction. For example, notice periods, lock-ups, and redemption caps are at odds with existing law for US funds under the Investment Company Act of 1940. They also have potential downstream operational impacts for funds and distribution channels. The IOSCO Recommendations rightly acknowledge both operational and regulatory realities and should continue to do so. To the extent there are regulatory implications, IOSCO recommendations should bias in favor of reducing regulatory impediments or mandates and giving funds all available tools to manage liquidity risk. One-size-fits-all solutions will inherently be constraining and an awkward fit for all.

Fourth, mechanisms such as temporary redemption suspensions or redemption caps can have the effect of accelerating outflows rather than mitigating them. Money market funds in the United States experienced this effect when they were obliged by law to impose such features. The SEC later rescinded such requirements. Notice periods can also be a helpful feature in times of market stress. Private funds, for example, have typically maintained longer notice periods or longer periods to meet redemptions than registered funds. Some private funds maintain mechanisms that allow them to flexibly waive or extend notice periods, as is warranted by market conditions. Where permitted by law, these mechanisms should be available to a fund if the fund believes it is appropriate or prudent

for their facts and circumstances but should not be mandatory. However, such measures should not be mandated by law for all funds, all strategies and all asset classes.

2. **Are there any other key considerations related to the availability and use of anti-dilution LMTs, quantity-based LMTs and other liquidity management measures under normal and stressed market conditions?**

Material Dilution

Recommendation 6 envisions a broad set of liquidity management tools. The associated commentary includes LMTs and suggests that "[i]ncorporating anti-dilution LMTs in the daily operation of an EOF and 'normaising' their use, as opposed to using them only in times of stress, helps enhances their effectiveness and avoid a 'cliff-edge' effect."

Recommendation 7 explicitly and rightly focuses LMTs on material dilution. However, market conditions where material dilution is a potential risk are unlikely to be ordinary market conditions. Some measure of stress is likely to be involved to widen bid-ask spreads beyond normal levels. The notions of employing LMTs on a daily basis but only when there is material dilution are potentially contradictory.

The commentary for Recommendation 6 rightly references the role of materiality in LMT deployment. The Recommendations and associated commentary should avoid suggesting that LMT use should be part of daily fund operations as a mechanism to address non-material dilution, in either normal or stressed market conditions.

Creating Run Risk

The commentary associated with Recommendation 6 rightly notes the risks of relying on quantity-based LMTs. Mechanisms such as temporary redemption suspensions or redemption caps can have the effect of accelerating outflows rather than mitigating them. Money market funds in the United States experienced this effect when they were obliged by law to impose such features. The SEC later rescinded such requirements. Where permitted by law, these mechanisms should be available to a fund if the fund believes it is appropriate or prudent for their facts and circumstances but should not be mandatory. Private funds, for example, have typically maintained longer notice periods or longer periods to meet redemptions than registered funds. However, such measures should not be mandated by law for all funds, all strategies and all asset classes.

LMT First Mover Premise Remains Unvalidated

The July 2023 IOSCO Consultation assessment stated that "[i]t is difficult to quantify and determine the materiality" of a potential first mover advantage. Questions remain about the rationale that LMTs solve a "first mover" advantage caused by investors moving quickly to avoid transaction costs. This motivation for investor behavior remains unvalidated.

Investors are driven by the desire to move out of a fund, strategy and/or asset class for investment reasons rather than transaction cost avoidance reasons. In times of stress, flights to quality to preserve capital are a major part of investor behavior and could overwhelm concern about avoiding transaction costs. Further work is required to confirm that transaction cost avoidance actually drives significant investor redemption behavior and therefore LMTs would have a positive impact for funds and the market.

LMT Principles

To the extent that dialogue regarding LMTs continues, the following key principles should guide the discussion.

- Shareholders come first. Any solution needs to be in their best interests and balance costs against benefits, avoid impairing the product or their investing experience. There must be compelling and demonstrative benefits before imposing new costs and burdens.

- Simple and stable solutions are best.
  - Solutions must be understandable to shareholders.
  - Minimize impact on existing timelines, technology, workflows, and operations.
  - Minimize impacts on distributors, intermediaries, recordkeepers and others in similar roles downstream of funds and fund decisions.
  - Solutions need to be reasonably stable over the long term. Frequent changes are difficult to administer and can cause shareholder confusion.

- Any LMT must retain a link to material dilution. A blunt tool used solely to discourage redemptions (rather than address dilution) loses credibility. Any concept to enhance dilution risk management recognizes that:
  - Funds have inherent incentives to minimize transaction costs because costs reduce performance.
  - Material dilution does not always exist.
  - LMTs should not be employed in ordinary market conditions.
  - Maintenance and administration of LMTs imposes a cost on shareholders. Even if not applied regularly, maintaining infrastructure at the ready is costly. LMTs should only be employed when there is a compelling benefit to address material dilution. Otherwise, funds should not be obliged to maintain LMT mechanisms.

- Funds rather than regulators are best positioned to assess dilution and tailor LMT tools for different dilution magnitudes, strategies, and shareholder bases. Keep board or other oversight body involvement consistent with oversight rather than operations.

- Chasing precision has diminishing returns. Practicable rather than certain is sufficient.
  - Reasonable methodologies for identifying material dilution and calculating fees/factors warrant good faith deference.
  - Stable fees/factors are more viable than constantly changing fees/factors.
  - Balance risks of undercharging and overcharging exiting shareholders.

    - Market impact estimates are incapable of reliable and credible models or measurements, especially when being used to calculate actual costs to shareholders.

- Stable but flexible
    - Periodically re-validate dilution assessment, measures and fee/factor calculations.
    - Retain agility to change fees and factors for significant market developments.

- Honor local market, operational and regulatory realities
    - US regulations do not easily accommodate redemption suspensions or side pockets.
    - In-kind distributions may not be feasible for certain instruments, omnibus and other distribution arrangements, or retail shareholders.

- No credible mechanism should be prohibited. No regulator should define a list of permitted tools and potentially preclude a new and innovative future idea. New or different approaches ought to be feasible if they meet the same principles and policy objectives.

Defer to Funds

Given those principles, not all funds require active anti-dilution programs. Maintenance and administration of LMTs imposes a cost on shareholders – even if never activated. LMTs should only be employed when there is a compelling benefit to address material dilution that outweighs the costs. Otherwise, funds should not be obliged to maintain LMT mechanisms and regulators should defer to the judgment of the fund and manager to determine whether anti-dilution measures are necessary or appropriate for their fund and, if so, what specific anti-dilution measures are appropriate for their fund.

Factors considered by a fund include, but are not limited to other regulatory implications, shareholder acceptance, assets, strategy, shareholder concentration, distribution (*i.e.,* implications for intermediaries and retirement platforms), practicality of implementation, availability of data, and potential benefit for the costs and burdens involved. These elements are not a checklist but are illustrations of factors that a fund could incorporate into its considerations. A fund with unconcentrated but highly liquid holdings and a diverse shareholder base that trades infrequently has a low risk of material dilution. A fund should have the deference to assess its facts and options and make decisions it believes are in the best interest of its shareholders.

LMTs might not always be Viable

In addition to fund holdings/instruments or strategy, there are valid reasons why an LMT may not be available, reasonable, or warranted for a fund to implement. For example, swing pricing might not be viable because of unavailable timely fund flow information, liquidity fees may not be viable because the funds are wrapped into other insurance or contractual arrangements prohibiting added fees and dual NAV may not be viable because of the major operational and technology overhaul required. Bid-ask pricing based on direction of flows may not be viable because of the lack of timely flow information and market trading conventions that utilize bid-ask pricing only in certain asset classes. LMTs also may not be compatible with fund distributors and the various systems for processing and keeping records of fund investor activity.

Market participants may not be able to accurately and credibly identify and measure "slippage" or "market impact." While interest in the concept of including implicit costs is understandable in theory, a regulatory mechanism will not credibly establish a credible, repeatable, and objective means of measuring implicit costs through "market impact" or "slippage."

The number of dynamic market factors involved makes such estimates inappropriate inputs for assessing actual costs to shareholders. This is particularly the case for fixed-income instruments where variances in bid-offer spread changes, differences based on size, and dislocations between and among sectors and sub-sectors are integral characteristics of liquidity at any point in time.

3. **Are there any other LMTs or liquidity management measures commonly used by OEF managers?**

The LMT measures described in the Recommendations broadly focus on structural elements of vehicles, product design decisions, and anti-dilution mechanisms. It should be recognized that asset managers continually consider liquidity in their portfolio construction decisions. Various managers use different tools to assess their portfolios and make risk-informed decisions. Some may be sophisticated, and others may be more rudimentary. With the breadth of experience and knowledge among investment and risk professionals and the availability of technology and data, asset managers can tailor their own day-to-day tools for monitoring and managing liquidity.

It would be infeasible and imprudent to dictate how asset managers make asset management judgments. It would restrict competition and limit innovation, both of which would adversely impact investors.

Any guidance, recommendations or regulations on liquidity risk management for funds should honor the foundational principles of letting funds determine how best to meet the needs of their clients and investors. It would be a mistake to let "common practices" become a list of "permitted practices" to the exclusion of other measures with merit.

4. **Have the proposed changes covered all the essential elements regarding liquidity risk management governance arrangements in relation to the use of liquidity management tools and other liquidity management measures? Are they proportionate to the differing size and complexity of responsible entities' fund ranges?**

<u>Organizational Infrastructure to Maintain LMTs</u>

Each fund should be able to design their own liquidity risk programs, how those programs are structured and operated, and how best to effectively meet investor needs and regulatory requirements. Any regulatory guidance should not attempt to define or mandate prescriptive elements of fund operations. The magnitude of resources and cost required to design, implement, and administer LMTs should be proportionate to the potential benefits. A single fund with low risk

for material dilution risk should not need the same infrastructure and governance of a fund complex with much higher risks.

The breadth of business models and organizational structures makes it challenging to design, implement and administer common programs. In some cases, funds may already have structures where it makes sense to incorporate consideration of dilution risk rather than create stand-alone groups or committees. In other cases, funds retain one or more sub-advisers so there is a distinct separation between those who are responsible for fund valuation, distribution, and administration and those who make investment decisions. Sub-advisory structures often span the globe with a fund domiciled in one continent and investment decision making located multiple time zones ahead or behind. Guidance should not presume a particular business model or organizational structure.

In addition, funds may not have the internal expertise or tools to maintain a comprehensive LMT framework. Funds may find it necessary or prudent to engage third parties, particularly with the amount of data analysis and calculations that could potentially be involved.

Regulatory guidance should be neutral on the use of third parties, but should recognize that involvement of third parties is a possibility which further illustrates that deference should be given to funds to organize and structure its own effort.

LMT use should be limited to relevant funds with material dilution or a high risk of material dilution and not used in normal market conditions. Accordingly, while a fund might have an LMT mechanism prepared if needed, the LMT may not play a large role in "day to day" liquidity risk management.

5. **Please describe any material factors of the liquidity risk management governance and oversight arrangements which have not been included.**

Stress Testing Limitations

Reasonable stress testing can be a means of ongoing validation of product design decisions at fund inception. Funds working in good faith could find that facts and circumstances have changed, and stress testing is one avenue of good practice to facilitate ongoing internal awareness of liquidity risk management.

Four cautionary notes are relevant for stress testing. First, stressed scenarios cannot be the baseline for ordinary fund operations. Most day-to-day market conditions are not stressed. Assuming a worst case scenario for all market conditions and managing a fund's holdings as if the worst case scenario is real would impose costs on fund shareholders. At a minimum, investors would be deprived of returns that assets with higher risk-reward can provide. Strategies that are designed to seek returns rather than preserve capital would be infeasible. Stress testing can be a useful tool, but IOSCO recommendations should not imply that funds should manage their assets in all market conditions presuming worst case stressed scenarios.

Second, stress testing is not a panacea. It may be very useful to facilitate internal dialogue and decision making, but loses its effectiveness if it becomes formulaic and inflexible. In particular, stress testing is not a crystal ball. IOSCO recommendations should affirmatively refrain from the temptation to state or imply that stress testing can reliably pre-empt or predict sharp market changes. There is a material difference between using stress testing to help position a fund while markets are otherwise ordinary and functioning and using stress tests to predict the future.

Third, stress testing should not be static by regulation. Funds with their own investment and risk professionals have their own views and methodologies and tools to assess and manage risk. New ideas emerge and old ideas evolve. Stress testing should never be set by regulation to be a single particular process or checklist. There should be no presumption that today's good ideas are the only good ideas that could ever exist.

Fourth, the commentary in the IOSCO consultation in support of Recommendation 12 rightly states that fund level stress tests may not be required where it would be disproportionate, taking in account the size, investment strategy, nature of the underlying assets and investor profile of the fund. There is an element of cost and administrative burden associated with conducting stress tests and considering results for potential action. Disproportionate costs and burdens that could be required by regulation and do not have a compelling benefit for shareholders should be viewed skeptically. This principle applies to all aspects of liquidity risk management and fund management in general.

Calibrated Governance

Any recommendations must recognize the difference between a board exercising oversight and providing direction and becoming involved in operational decision making. There may be a temptation to presume that more involvement from a board will result in better shareholder outcomes. In some cases, that may be true, but board involvement should be appropriately calibrated.

Setting the bar too low for items that require immediate escalation results in over-reporting or escalation and adds operational friction in a process that otherwise requires full attention (especially in times of market stress). The end result might be more documentation of earnest labor but the labor might be better allocated to the primary goal of taking care of shareholder interests.

6. **What information can (and should) be disclosed to investors or the public, and within what timeframe should this information be disclosed to enhance transparency when responsible entities activate quantity-based LMTs or other liquidity management measures?**

LMT Disclosure Requires Balance

Investors should be given enough information prior to investing in the OEF to enable them to have a good understanding of the implications of anti-dilution LMTs. As a general matter, shareholders are entitled to clear disclosure regarding the material elements of funds in which they invest.

If the premise of an LMT is that investors need to know that transaction costs may be allocated to their redemption or subscription orders, disclosure that a fund has such a feature is sufficient. Funds can clearly disclose the presence and use of LMTs.

Specific details about the mechanism, calculations, trigger thresholds, ranges of cost adjustments, etc. are subject to board or other governing body oversight, but LMTs should be treated similar to other operational aspects of fund operations in terms of whether they are sufficiently material to warrant detailed disclosure.

Funds should not be required to publicly disclose threshold triggers or swing factors. Disclosure could provide an avenue for savvy investors to attempt to "game the system" by strategically timing their purchases and redemptions based on expected swings. Although a few European funds selectively disclose their swing factors and swing pricing thresholds, many have chosen not to publicly disclose this information and only disclose the maximum factors for these same reasons.

Shareholders should have a sense of the realistic maximum that they might be charged and a sense of whether such charges are applied in the ordinary course or limited to unusual circumstances. We believe that can be accomplished without providing a granular description of methodology, calculation inputs, etc.

Shareholder disclosure should be sufficiently evergreen such that a fund can change logistics and details of the LMTs without waiting to update prospectus disclosure for all shareholders or send update notices to all shareholders. LMT mechanics should be viewed like valuation methodologies – the relevant fund actors and committees are charged with maintaining the program and making changes but not every aspect of the program or change requires disclosure. This principle suggests that general disclosure about the presence of an LMT is preferred over more specific disclosure about the operation of an LMT.

Disclosure may be warranted for larger changes that directly impact operational logistics such as moving from swing pricing to liquidity fees or bid-ask pricing. Transparency would be prudent because shareholders would see differences in their trade order confirmations and need disclosure to understand the economics of their trade. In part, this is for the benefit of shareholders, but implementation logistics may also require notice to other impacted parties (such as intermediaries and recordkeepers). More disclosure and more preparation time required for implementation means that funds will not be able to quickly change LMTs being utilized.

If LMTs are authorized, ex-post reporting should be permitted but not mandated. If there is shareholder interest, funds could elect to disclose information about the magnitude and frequency of LMT adjustments and activations. Not all shareholders may be interested in the data or would take the data into account when they make investment decisions. Fund policy and practice is a balance that each individual fund should be able to set.

While shareholder transparency is generally preferable, individual shareholder interest in the granular details of estimates and calculations may impose operational cost and friction on the fund that other shareholders or the fund's sponsor and advisers would bear. It might also require disclosure of methodologies and mechanics that could give an individual shareholder an advantage over others.

Recommendations or guidance should recognize the role of the fund board or other oversight body and auditors rather than shareholders in terms of oversight of the mechanics of LMT tools.

7. **Do you have any comments on any of the other Proposed Revised Liquidity Recommendations put forth in this document?**

Scope

As a threshold matter, the scope of the IOSCO Consultation should exclude exchange traded funds and money market funds. The scope should be limited to public collective investment schemes rather than private fund vehicles. Private funds have very different investor profiles, use cases, distribution mechanisms, and regulatory regimes that limit public disclosure and communications.

Defer to Funds and Investors

All LMT solutions have trade-offs. The more complex, the more difficult to maintain and explain. If the tools are complex, they make disclosure and shareholder transparency more complex.

Open-end funds recognize the need to effectively manage liquidity risk, material dilution risk, and act in the interest of shareholders. With the wide breadth of funds with different managers, perspectives on strategies and investment decision-making, instruments and asset classes, and shareholder bases, it is critical to allow funds to retain the ability to make investment and product design decisions for themselves.

Funds manage liquidity, transaction costs, and the risk of dilution every day. Transaction costs directly erode performance. As fund managers are primarily judged on performance by investors and boards, the natural built-in incentives influence behavior. Likewise, funds manage liquidity risk and balance the need to meet shareholder redemptions with the desire to invest in assets that produce returns for shareholders.

Funds clearly disclose their investment objectives and provide ongoing reporting to shareholders, allowing investors to make informed decisions regarding whether to invest, how much to invest, and when to make changes. In a competitive market with a wide variety of options, shareholders make their own investing choices or rely on the assistance of financial advisors to help guide them.

If there is a compelling reason for additional regulatory measures to address liquidity and the risk of material dilution, any recommendations should be data-driven, use incremental measures that balance actual costs and potential benefits, preserve the role of the fund manager as the party best positioned to know their specific facts and circumstances, and avoid prescriptive frameworks build on estimates and data limited by artificial precision.

Identifying Future Liquidity Shortages Before they Occur

Recommendation 10 references a fund having a liquidity risk management process to "facilitate the ability of the responsible entity to identify an emerging liquidity shortage before it occurs." Funds

have no crystal ball and no way to tell the future, particularly with respect to exogenous market events. A fund can maintain vigilance for how it manages its affairs and the decisions it can control and mitigate the risk of being in a bad liquidity position. A fund can maintain flexibility and agility to address market conditions as they emerge and change. A fund can distinguish itself by decision making during a time of stress. IOSCO should not imply in any form, however, that funds have the ability to identify market events before they occur.