

**EFAMA Response to the FSB Consultative Document
Proposed Policy Recommendations to Address Structural Vulnerabilities
from Asset Management Activities**

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Preliminary comments

EFAMA firstly wishes to commend the FSB's change of focus in the course of 2015, from a proposed assessment methodology intended to identify non-bank, non-insurance globally systemically important financial institutions (NBNI G-SIFIs) to a revised and more objective focus on asset management activities. Although we understand the former framework may be revisited by the FSB once its Recommendations are finalised, we appreciate that certain key characteristics of the asset management industry have been recognised and well reflected in the present consultative document. However, we regret that the consultative document still reflects a series of common misconceptions, for instance around the systemic implications of the "first mover advantage", risks from asset "fire sales", etc.,

Before answering in more detail the specific questions raised in the consultative document, we wish to make the following general observations:

- Our opinion remains that the scope of the present FSB WS3 work still fails to adequately account for the behaviour of direct asset-owners, i.e. large institutional investors that choose to manage their funds in-house and/or rely on the services of investment advisors/consultants¹. This appears even more surprising on the basis of the FSB's own recognition in the final paragraph of Section 1.1 of the consultative document, citing recent work from PWC and McKinsey, "(...) that most financial market participants prefer to manage their investments on their own without the help of third-party asset managers"². The FSB draft Recommendations towards "system-wide" liquidity stress-tests, or a "simple and consistent" measure to gauge leverage "system-wide" should therefore not be "siloes" or limited uniquely to professional asset managers. Asset managers are

¹ For instance, Mercer, Cambridge Associates, Aon Hewitt, Russell Investments and Towers Watson to name only the largest.

² The cited paragraph goes further to confirm this fact: "Many sophisticated investors have their own asset management capacities in house. In fact, according to one source, third-party asset managers as a group only manage about one-third of the total financial assets of pension funds, SWFs, insurance companies and high net worth individuals. The remaining assets are managed by the investor or asset-owner without the help of independent asset managers." (Please refer to the final paragraph on page 7, Section 1.1 of the Background to the consultative document).

by the very nature of their “agency” business model implementing an investment mandate on behalf of investors. These, as ultimate asset-owners, remain free to (re)allocate their capital at all times. We therefore strongly encourage the FSB to adopt a more holistic approach to monitor financial market risks by looking at a wider spectrum of actors, e.g. from the large, direct asset-owners like SWFs to perhaps more remote cases where even individuals may destabilise markets³;

- Similarly, any “system-wide” exercise targeting asset managers would, to be meaningful, necessarily need to factor-in the multiple identities and behaviours of the ultimate asset-owners, i.e. the investors that entrust their funds to the professional asset managers. Unfortunately, to this day, no consistent data gathering effort outside individual asset management companies has been attempted to provide a more in-depth profile of investor types and certainly not for the purpose of financial stability monitoring purposes;
- In addition, we would note that the comprehensiveness of existing EU legislation, together with existing industry best practices (e.g. with respect to fund liquidity management), appropriately already addresses the types of financial stability risks described in the consultative document to a very large extent. We therefore do not see a need for additional recommendations deriving from the present FSB work-stream beyond a possible review by IOSCO of its 2013 *Principles of Liquidity Risk Management for Collective Investment Schemes*. This could be accompanied by the elaboration of a common global reporting template for funds to report their key characteristics across borders, thus facilitating IOSCO’s *Priorities Regarding Data Gaps in the Asset Management Industry*⁴. In this regard, the use of the G20/FSB-sponsored Legal Entity Identifier (LEI), together with ISIN codes, with Unique Transaction Identifier (UTI) codes for transactions and possibly with Unique Product Identifier (UPI) codes for products, should be opportunely leveraged;
- With regard to the first key structural vulnerability identified in the consultative document, i.e. that of a liquidity mismatch, we deem it important that, while delivering on its mandate stemming from the final FSB Recommendations, IOSCO’s Committee 5 cooperate closely with Committee 2 (on the Regulation of Secondary Markets). Committee 2 has recently published its preliminary findings on the state of liquidity in secondary bond markets, eliciting further public comments on the analysis, data and conclusions of its report⁵. It is paramount that these findings be reflected and inspire the work of Committee 5 in amending its 2013 *Principles*;
- Still too often investment risk is viewed only through the prism of financial stability. In reality, financial markets exist and are able to function precisely because myriads of different actors decide to take-on risk as an inseparable component of economic activity. As risk is inalienable from financial markets, there are several categories of risk, as many as there are investable securities to which investors may decide to allocate their capital. Returns from these allocations are a function

³ In this regard, well documented in the financial press were the dwindling fortunes, towards the end of 2016/early 2016, of large SWFs established in certain commodity-dependant jurisdictions. For instance, please refer to the *Financial Times* article “Sovereign wealth funds drive turbulent trading” of 1 February 2016; available at: <http://www.ft.com/cms/s/0/55470a6c-c68f-11e5-808f-8231cd71622e.html#axzz4Ki9GM125>. Less common, although with some potential to de-stabilise certain markets, is the recent case of a London-based trader, Navinder Singh Sarao, who has been criminally charged with “spoofing” in stock index futures.

⁴ Please refer to IOSCO’s relevant statement of June 2016; available at: <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD533.pdf>

⁵ Please refer to the IOSCO Report published on 5 August 2016, entitled *Examination of Liquidity of the Secondary Corporate Bond Markets*; available at: <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD537.pdf>

of several factors and amongst these is the relative degree of liquidity of a given security compared to others. It is a generally known fact that investors are typically rewarded greater returns where they opt to invest in less-liquid securities (the so-called “liquidity premium”). Unlike the conclusions of some of the referenced academic literature in the consultative document⁶, we are of the view that investments in less-liquid asset classes are by no means a “fragility” *per se* and that more appropriate conclusions as to their alleged “contagion” effects on other asset classes and into the broader market ought to be appreciated with a clear understanding of investor profiles and of their investment perspectives (especially in terms of diversifying their exposure over the longer term);

- In addition, market liquidity should be recognised as a “state” that is both unique and dynamic in that it depends on several varying factors; it is not a static measure used to judge the riskiness of an investment once and for all, for the purpose of drawing policy conclusions via a “one-size-fit-all” proposition. We would therefore encourage the FSB to move its thinking away from a strict, one-sided view of investment risk (common to a series of theoretical academic studies as also cited in the consultative document), consider investment returns as a key factor behind liquidity conditions and as a driver of fund flows, and acknowledge the notorious risk/reward trade-off as a market reality that should not be denied;
- Regarding the proposal for authorities to consider “system-wide stress-testing” to improve monitoring the resilience of financial markets to collective selling by funds and other market actors, we consider that the required data collection, its aggregation and elaboration would present a challenging task for regulatory authorities with very uncertain outcomes. We are conscious of multiple data gaps, even outside our own industry, that remain a concrete obstacle to this endeavour, as of the infinite fallacies implicit in any attempt to model the behaviour of an entire universe of market actors, their decision makers and choices of their clients, let alone their complex interactions on global exchanges, alternative trading venues, CCPs and other forms of market infrastructures. **For these reasons, we consider that any “top-down” attempt to reduce the complexity of the global financial system to a single stress-test should be abandoned in favour of a principles-based framework, leaving it to an individual player’s responsibility to assess market conditions and to stress-test accordingly on the basis of its own information, business model, client types, regulatory obligations, etc.;**
- Similarly, we believe that the intent of devising a “simple and consistent” measure of gauging fund leverage for the purpose of making it comparable to measures used by other financial entities may be difficult to achieve in practice, given the significant diversity of different actors’ business models and the extraordinary diversity within the global asset management industry (and beyond) of investment strategies, asset types and, most importantly, of investor profiles. **EFAMA would alternatively recommend that the current calculation methodologies recognised across several jurisdictions be preserved as a better mean to account for our industry’s diversity. Eventually, given the complexity of the topic, we would alternatively recommend that it be “unbundled” from the present consultation and entrusted to IOSCO for a more thorough and dedicated consultation on whether existing investment fund leverage indicators could be applied more broadly across the financial system, accompanied by further analysis.**

⁶ For instance, the references to a body of academic work produced by the IMF et al. under footnotes 28 and 29 of the consultative document.

Introduction

Q1. Does this consultative document adequately identify the structural vulnerabilities associated with asset management activities that may pose risks to financial stability? Are there additional structural vulnerabilities associated with asset management activities that the FSB should address? If there are any, please identify them, as well as any potential recommendations for the FSB's consideration.

From a purely theoretical standpoint, we agree with the FSB that there may be some inherent or structural vulnerabilities in asset management activities, as presented in the consultative document. Their identification is, however, not new to the regulatory community. In fact, these same vulnerabilities have largely inspired extensive regulation in the EU, as elsewhere, most of which pre-dates the recent global financial crisis of 2008 and its aftermath. We refer in particular to those potential vulnerabilities the FSB has identified as “key”, namely a liquidity mismatch and leverage within investment funds, as these have been tackled via the piecemeal amendments to the UCITS Directive, and more recently under the provisions of the AIFM Directive, supported by a raft of more detailed implementing measures. The more recent concerns as to potential operational vulnerabilities tied to the transfer of mandates between asset management companies under abnormal market conditions, as well as those assumed to be inherent to the indemnification programmes to a few large lenders, would in our view deserve to be dismissed on the basis of the arguments presented further below.

With the exception of certain types of money market funds (MMFs) – as also noted in the introduction to the consultative document – existing regulatory requirements have provided a solid and effective framework within which such potential vulnerabilities and resulting impact on financial stability have been adequately contained until this day. This conclusion chimes with the FSB's observation in the aforementioned introduction, whereby “(...) evidence suggests that most open-ended funds have been generally resilient (...)”, even in the context of significant market disruptions over the last three years (e.g. from 2013 Fed “taper” to the Eurozone Crisis, from two repeated collapses of the Chinese mainland equity markets by mid- and end-2015, to the most recent “Brexit” aftermath in the United Kingdom). There is a general understanding in the asset management community that the market environment will remain particularly challenging for some time to come, where sudden bouts of volatility are expected on the back of exogenous events, as assets reprice and asset managers reconsider their clients' exposures, but claims around the “systemic” nature of these risks and the potential application of additional consequent measures drawn up in haste to address them, should be avoided. In particular, as long as sufficient evidence is not gathered, made available and prove convincing.

As to additional potential vulnerabilities beyond the four presented in the consultative document, EFAMA is not aware of any further one that would merit global regulatory attention.

Q2. Do the proposed policy recommendations in the document adequately address the structural vulnerabilities identified? Are there alternative or additional approaches to risk mitigation (including existing regulatory or other mitigants) that the FSB should consider to address financial stability risks from structural vulnerabilities associated with asset management activities? If so, please describe them and explain how they address the risks. Are they likely to be adequate in stressed market conditions and, if so, how?

Subject to our observations presented under Q1. above, EFAMA generally agrees that the proposed draft Recommendations are generally in line with adequately addressing the potential vulnerabilities as identified, albeit with a number of reservations on some of the draft Recommendations presented below.

Q3. In your view, are there any practical difficulties or unintended consequences that may be associated with implementing the proposed policy recommendations, either within a jurisdiction or across jurisdictions? If there are any, please identify the recommendation(s) and explain the challenges as well as potential ways to address the challenges and promote implementation within a jurisdiction or across jurisdictions.

Our reservations would relate to the following draft Recommendations, to be elaborated in the course of our response:

- Concerning the draft **Recommendation 9**, our view is that that a “system-wide” stress-test would be impossible to implement. Apart from requiring an enormous aggregation effort, considerable human capital and costly computing power by those intended to administer it, its underlying assumptions remain flawed in our view. As long as “system-wide” data remains globally incomplete and with the stress-test design failing to account for a series of key qualitative assumptions and a certain degree of judgment (especially around the complex notion of “liquidity”), such proposal will not deliver the intended purpose (as we shall argue further below in our response to Q.4);
- Concerning the draft **Recommendation 10**, considering the opportunity to develop a “simple and consistent” measure(s) of leverage, we would note that this would be already given by the standard definition of leverage expressed as a given fund’s total exposure (in net or in gross terms), divided by the fund’s total NAV. Given the diversity of fund structures across jurisdictions, measuring the total exposure (i.e. the numerator) should not warrant a “one-size-fit-all” approach. For instance, reflecting the fundamental differences between UCITS and AIF structures in Europe, the EU Legislator has recognised at least three different calculation methods to calculate total exposure (as further refined in implementing regulations and Guidelines around the EU UCITS and AIFM Directives) for a specific purpose. For these reasons, to be further elaborated in our responses below, we strongly doubt a “simple and consistent” measure(s) of leverage, if feasible, would be informative at all. Alternatively, we would recommend that current calculation methodologies – as tried and tested in Europe for several years - be preserved; and
- Concerning the draft **Recommendation 12**, proposing that IOSCO collect national/regional aggregated data on leverage from member jurisdictions, we would note, in theory, that as a necessary pre-condition for this data to be sufficiently informative, both fund portfolio and investor categorisations would need to be far more detailed than presently possible. For the measurement to be significant, there would also need to be a globally agreed fund categorisation

and a common regulatory understanding of a considerable number of different investment strategies⁷. Only then could aggregating individual leverage figures across funds with identical or very similar asset/liability profiles, as well as investment strategies, yield a rough estimate of the desired degree of leverage, albeit it would represent only one (probably small) corner of our industry. Yet, such measure would not account for the infinite degrees of interactions between investment funds, their investors and other third-party intermediaries. As we shall further elaborate, for the financial stability monitoring purposes of the FSB, such global estimate would therefore still have little value.

From a European perspective, in light of the relevance of the first vulnerability identified (i.e. liquidity mismatch), EFAMA invites the FSB to refer to Annex I of this response providing a more detailed elaboration on the liquidity management framework relevant for UCITS and AIF funds, as regulated by their own respective EU directives and implementing measures.

Liquidity mismatch between fund investment assets and redemption terms and conditions for fund units

EFAMA welcomes, at the outset of the consultative document's Section 2, the FSB's recognition of the "countering factors" that would remove the incentives behind a "first-mover advantage" in open-end funds, as well as its recognition of the several and only eventual "contingencies" that would need to materialise for liquidity transformation in these funds to affect financial stability more broadly. We would also agree that leveraged investors could in theory amplify a market sell-off when attempting to unwind their position. Although generally true in abstract terms, the above should be tested with concrete facts, i.e. for a given asset class, the percentage of assets actually held or traded by third-party asset managers against their total amounts outstanding held directly by other actors in the market or traded in total volumes. The same considerations hold true when addressing leverage, beckoning the question of how large are leveraged funds' positions collectively compared to those of other larger and truly systemic market players (i.e. banks and broker/dealers). We find that many of the academic papers referenced in the consultative document fail to factor-in these key variables, let alone the opportunity for asset managers to activate an entire range of liquidity management tools, especially with regard to fund flow dynamics over recent periods of market stress, thereby remaining abstract in their conclusions and thus hardly credible.

We also welcome the few considerations made around the evolving market structure. We wish to caution, however, that a transition from the centrality of the traditional broker/dealer intermediary model to new forms of intermediation (or "dis-intermediation") has only commenced. In fact, post-Basel III, sell-side institutions appear to have modified their service provision to buy-side clients, thereby acting less as "principals" and more on an "agency" basis. On their part, buy-side institutions have forged deeper ties with those broker/dealers which are better able and willing to facilitate trades, while also frequently taking a more active role in price-formation. On this basis, there is little reason to doubt that the importance of sell-side institutions will remain pivotal in their growing and mutual inter-dependence with the buy-side, albeit concomitantly with the potential for alternative forms of

⁷ For instance, to name only a few, passive vs. active, and within the latter long/short equity, dedicated short, equity market neutral, distressed debt, merger arbitrage, convertible arbitrage, fixed income arbitrage, emerging markets, global macro, managed futures, CTAs, et al.

liquidity provisions (e.g. from internal buy-side crossing networks to the progressive “electronification” of venues to trade non-equity instruments, the development of “all-to-all” open trading protocols, etc.)⁸.

We also appreciate that several of our considerations around the comprehensiveness of existing regulatory requirements and available risk-mitigating tools⁹, as per our earlier responses to the two joint FSB/IOSCO consultations of 2014 and 2015, have been reflected in the consultative document in its overview of existing mitigants to address the alleged vulnerabilities (Section 2.2 thereof). Nevertheless, it is very surprising that the consultative document’s narrative pivots back to the FSB’s long-held assumptions, which remain largely unproven, that there are systemic risks from asset management activities. The following passage is particularly illustrative of this approach: “However, the tools could potentially have spill-over effects, particularly if they contribute to liquidity strains for investors or give rise to speculation of further measures and contribute to runs from other funds. In addition, the use of credit facilities to meet redemptions introduces leverage to a fund that is already under stress and may exacerbate strains if redemptions do not abate.” As per our 2014 and 2015 submissions to the FSB/IOSCO, we care to note that mere conjectures, not supported by any evidence or significant probability, do not properly inform a policy debate.

As per our preliminary remarks at the outset of our response, we also fundamentally disagree with the FSB’s statement that market supervisors’ pre-emptive intervention powers may be “limited” and that consequently these may not be aware of any build-up of sector-wide risks. We refrain from further comments under this section, but elaborate more extensively on this aspect in the next section concerning leverage. We note, however, with regard to those “residual” liquidity risks under Section 2.3 of the consultative document, that regulatory reporting requirements under EU law are extensive enough for the supervisory authorities to form a fairly accurate analysis as to whether there are significant “liquidity risks” present in the funds they directly supervise. For fund investors, the same conclusion holds true. More information on these requirements is presented in Annex II, demonstrating the extent to which UCITS/AIF regulators and investors alike have access to information as to the liquidity profile of the funds they respectively supervise and invest in. Should the FSB otherwise continue to deem that regulatory reporting is, at the present state, insufficient – as per residual risk (i) defined under Section 2.3 – it may be that data reported to supervisory authorities remains inconsistent and these, together with investors, may not be making full use of the information contained in the mandatory EU disclosures.

Were investor disclosure requirements to be reviewed – as per the draft Recommendation 2 – we would caution against the prescriptive publication of too granular liquidity metrics investors (even those more financially savvy) would have trouble understanding without accounting for a portfolio managers’ internal assumptions, as well as myriads of complementary sources of information contingent of markets at one given moment. Such information would inevitably become stale after a short period and easily draw investors to erroneous conclusions. Rather, we propose that eventual

⁸ Please refer to the ICMA Study *Remaking the corporate bond market – ICMA’s 2nd study into the state and evolution of the European investment grade corporate bond secondary market*, published in July 2016; available at: <http://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/Secondary-Markets/survey-report-liquidity-in-the-european-secondary-bond-market-perspectives-from-the-market/>

⁹ As presented in the FSB’s *Policy Framework for Strengthening Oversight and Regulation of Shadow Banking Entities* of August 2013, and more recently, by IOSCO’s December 2015 findings of its report on *Liquidity Management Tools in Collective Investment Schemes*.

work by IOSCO could improve the disclosure of liquidity risks, and specifically, of which tools asset managers dispose of, including a summary description of the circumstances which may lead to their activation. In this regard, there should be a clear differentiation as to the granularity that is provided between disclosures to regulators on the one hand, and those to investors on the other.

Another observation would relate to the FSB's claim – as per residual risk (iii) defined under Section 2.3 of the consultative document – that discretionary liquidity management tools to deal with exceptional circumstances may not function as effectively. Such claim is accompanied by further predictions around the potential spill-over effects on investors and other funds triggered by the activation of redemption gates and suspensions, or around reputation risks which may, alongside other “impediments”, prove the discretionary liquidity management tools to be ineffective. EFAMA wishes to point out that such predictions have systematically failed to gather sufficient evidence to their credit and that even where certain patterns have materialised – e.g. the suspension of redemptions for a number of open-end, commercial property funds in the wake of the “Brexit” referendum vote of June 2016 in the United Kingdom – the financial stability of the domestic market, let alone the global one, was by no means imperilled. As per our earlier submissions, we would refer the FSB to consider, in particular, the behaviour of fixed income investors in the context of recent episodes of market turbulence. We notice, in this regard, that the hypothetical conclusions drawn in the consultative paper shall continue to remain flawed to the extent they fail to account for underlying key factors, as for instance, the diversity of a fund's or management company's investor base, a more granular breakdown of investible assets within a broad asset class like fixed income (e.g. by issuer, by maturity, sector-specific vs. multi-sector, index vs. active, etc.), the availability of liquid derivatives as a cheaper alternative to underlying cash markets, use of ETFs as additional sources of liquidity¹⁰, to name only the most evident¹¹.

Q4. In your view, is the scope of the proposed recommendations on open-ended fund liquidity mismatch appropriate? Should any additional types of funds be covered? Should the proposed recommendations be tailored in any way for ETFs?

EFAMA agrees with and supports the FSB's first eight draft Recommendations, noting how these are already largely reflected and further specified into binding EU law that is transposed and applied by each national competent authority of the EU Member States in their own jurisdiction. As an example, with respect to draft Recommendation 1, in terms of information collected by these authorities on the

¹⁰ With regard to ETFs, data into high yield ETF trading volumes in the aftermath of Third Avenue Management Company, announcing that it would suspend all redemptions and liquidate its Focused Credit Fund (TFCIX) in December 2015, demonstrates that these experienced significant trading volumes in their secondary market for shares (according to estimates, on 11 December 2015, high-yield bond ETFs traded an estimated USD 6.1 billion on exchanges *vis-à-vis* some USD 9.5 billion in the primary market). As with analogous episodes observed following the departure of the “star” manager, William Gross, from the asset management company PIMCO, ETFs provide greater market liquidity by attracting some portion of trading away from high-yield cash markets, thereby dampening the overall market impact of reactions to certain announcements. For a detailed study of the Third Avenue case, please refer to a Special Report prepared by Blackrock and shared with the U.S. SEC, *High Yield Case Study: Post Closing of the Third Avenue Focused Credit Fund* of January 2016; available at: <https://www.sec.gov/comments/s7-16-15/s71615-86.pdf>

¹¹ As an example of how important such factors are at explaining recent investor behaviours in light of real market conditions, please refer to an insightful *Viewpoint* prepared by Blackrock, *Breaking down the data: A Closer Look at Bond Fund AUM*, as published in June 2016; available at: <https://www.blackrock.com/corporate/en-il/literature/whitepaper/viewpoint-breaking-down-the-data-bond-fund-aum-june-2016.pdf>

liquidity profile of open-end funds in their jurisdiction, we would refer the FSB to some of the detailed requirements of the ESMA consolidated template for reporting under some of the provisions of the AIFM Directive (presented in Annex III of our response), as further specified by the relative set of ESMA *Guidelines* (as revised in August 2014)¹². We believe that on the basis of such disclosures, market supervisors would be able to obtain an accurate account of an AIF's liquidity profile at any given moment. Whether such information may be aggregated and shared with other regional or global bodies, including IOSCO, for the purpose of monitoring financial stability risks on an ongoing basis should be considered by national market supervisors as a matter of priority and possibly by devising a globally harmonised data reporting template under the aegis of IOSCO. As a basis for this work, we would recommend leveraging the G20/FSB-sponsored initiatives aimed at harmonising cross-border reporting standards and ones that EFAMA has openly supported.

As anticipated above, we dissent with the proposed draft Recommendation 9 which envisages the administration of system-wide stress-tests to model the effects of large asset sales involving an entire universe of very different market actors. On the basis of the evidence gathered and for the reasons as to why investors do not decide to exit markets all at once, we believe that system-wide stress-tests would be fundamentally inappropriate, as well as impossibly burdensome for those intending to implement them. Additional considerations questioning their utility would be the following:

- From the historical evidence gathered, including across a series of more recent case studies into episodes of market turbulence, investors' behaviour proves that these are not a homogenous mass, displaying very diverse subscription/redemption patterns observed under different market conditions and whose effective responses to market events suggest multiple patterns. In essence, investors do not all sell their units *en masse* to drive a market in one sole direction as per one of the FSB's core hypothesis. Please refer to the evidence provided for European high-yield bond and for UCITS bond funds in Box I below, regarding to investor flow patterns observed during the 2008 – 2016 period;
- The variety of fund structures spanning multiple jurisdictions is such that their unique exposures can simply not be summed-up or reduced to one or a few aggregated variables for the purpose of a system-wide stress-test;
- Given the way stress-tests are performed as per legal requirements in Europe, there are necessarily also qualitative factors and a sound degree of judgment that must be exercised for the purpose of properly stress-testing a fund. For results of a system-wide stress-test to yield appreciable results, these two factors need to be accounted for;
- To be meaningful, any system-wide stress-test must necessarily also attempt to model the asset allocation decisions of the direct asset-owners to whom portfolio managers are accountable in light of their own fiduciary duties; and
- We logically do not see how such a "top-down" exercise would adequately consider the eventual likelihood of asset managers deciding, at times in coordination with their supervisory authority, to activate some of their traditional liquidity risk management tools at a given moment.

As to whether there should be additional Recommendations tailored to ETFs, we believe there should not. Virtually all ETFs trading on European exchanges and being offered to a European investor public

¹² Please refer to the ESMA consolidated reporting template (ESMA/2013/1359) for regulatory disclosures under Article 24(2) of the AIFM Directive, accompanied by the relative *Guidelines* on reporting obligations under Articles 3(3)(d) and 24(1), (2) and (4) of the AIFMD (ESMA/2014/869).

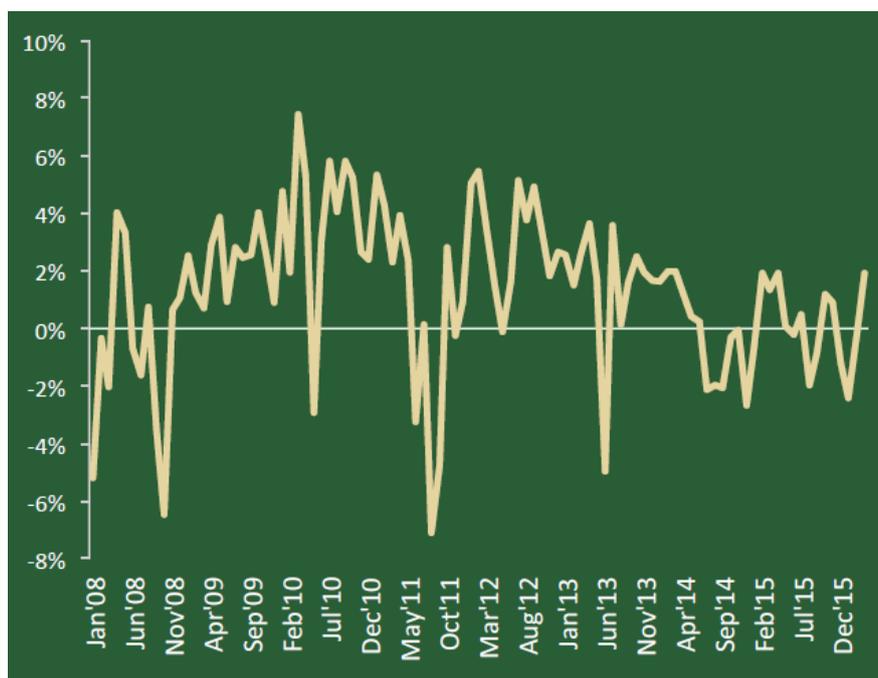
(professional and retail) are authorised as UCITS structures, conforming to the directive's own prescriptive liquidity risk management requirements, as well as to the more recent ESMA 2012 *Guidelines on ETFs and other UCITS issues* (as revised in 2014) which have expanded liquidity requirements to received collateral from OTC derivative transaction, as from "efficient portfolio management techniques" (i.e. repo and securities lending). A new requirement also worthy of mention introduced by the ESMA *Guidelines* is the possibility for the ETF investors to redeem directly from the ETF fund provider (instead of from the authorised participant or "AP" only, as per ETFs' unique structure). Such occasion would materialise where the stock exchange value of the units or shares of the UCITS ETF significantly varies from its net asset value (NAV) and where an AP is no longer able or willing to act as a market maker. Such circumstances would be extremely rare, as typically ETF providers may count on multiple APs to continue providing the two-way pricing of shares for a specific ETF. In the rare instance of there being only a single AP, investors who have acquired their units or shares on the secondary market would under ESMA's rules be allowed to sell them directly back to the UCITS ETF (rather than to the AP in its market-making role). In such situations, ESMA clearly foresees that information should be communicated to the regulated market, indicating that the ETF is open for direct redemptions¹³. To note is that such circumstances would also be short-lived as the gap between the price of the ETF share and the fund's NAV would normalise, inviting the AP to re-enter the market to profit from the discrepancy.

¹³ As an example, a large global ETF provider has communicated the opportunity of direct redemptions in the investor prospectus in the following way: "An investor (that is not an Authorised Participant) shall have the right, subject to compliance with relevant laws and regulations, to request that the Manager buys back its Shares in respect of a Fund in circumstances where the Manager has determined in its sole discretion that the Net Asset Value per Share of the Fund differs significantly to the value of a Share of the Fund traded on the Secondary Market, for example, where no Authorised Participants are acting, or willing to act, in such capacity in respect of the Fund (a "Secondary Market Disruption Event"). If, in the view of the Manager, a Secondary Market Disruption Event exists, the Manager will issue a "Non-AP Buy-Back Notice" and stock exchange announcement(s) containing the terms of acceptance, minimum redemption amount and contact details for the buy-back of Shares."

Box I – Evidence of investor flow patterns from European high-yield bond and UCITS bond funds during the 2008 – 2016 period

European high-yield bond funds experienced since 2009 a considerable growth in AuM, which was substantively driven by valuation effects. Flow patterns in the EU sector experienced three sharp downward jumps around September 2008, October 2011 and June 2013, with the biggest outflow representing 6% of managed assets.

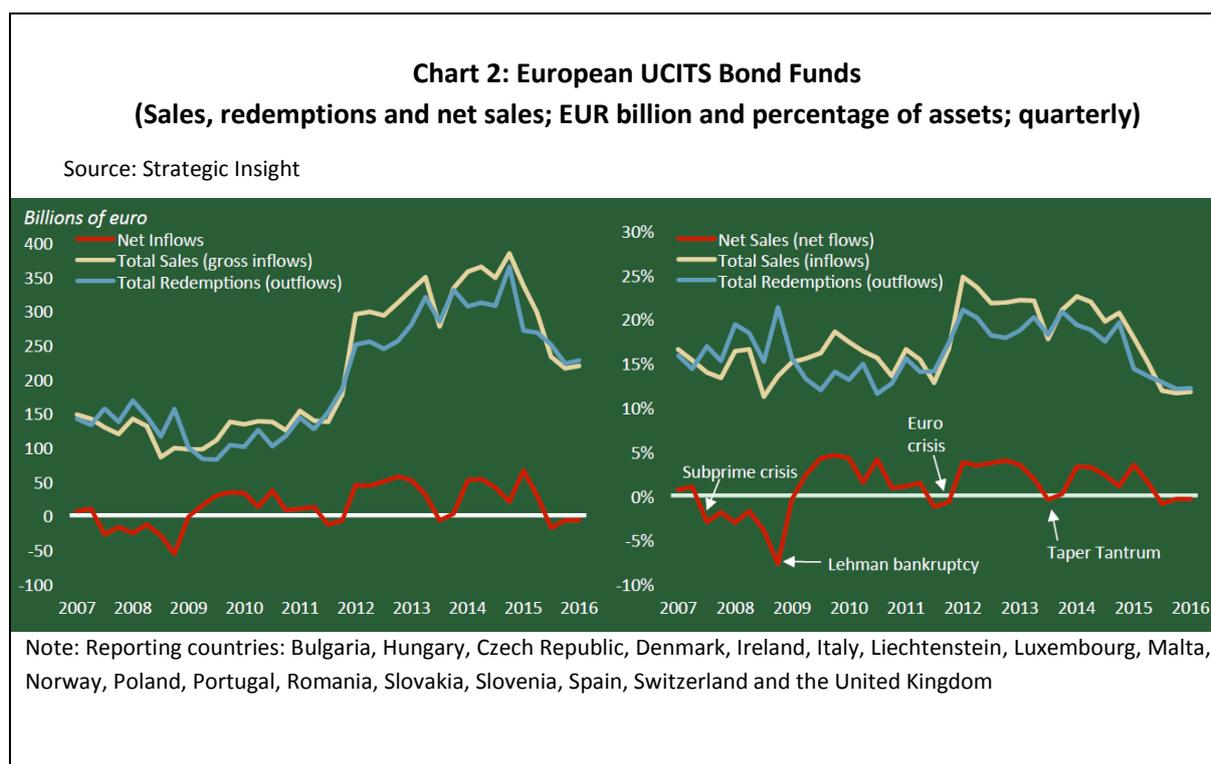
**Chart 1: European high-yield bond funds
(Net inflows in percentage of assets)**



Source: Strategic Insight

Turning to the potential systemic risk posed by European UCITS bond funds in general, it can be observed in the chart below that net outflows were restricted to periods of high stress in markets, with sales and redemptions tending to always move in parallel. The heterogeneity in the profiles of fund investors, which include different types of institutional investors as well as retail investors, provide an explanation for this. In particular insurance companies, pension funds and other financial institutions hold a substantive share in bond fund shares, with the potential room for redemptions quite restricted due to their own strategies and investment needs.

It is also important to note that any analysis of the bond fund sector should always compare the developments in different market segments as the category “bond funds” is not a homogenous group. The differentiation between idiosyncratic events affecting individual funds and sector-wide events is also key for meaningful analysis.



Q5. What liquidity risk management tools should be made available to funds? What tools most effectively promote consistency between investors' redemption behaviours and the liquidity profiles of funds? For example, could redemption fees be used for this purpose separate and apart from any impact they may have on first-mover advantage?

EFAMA would observe that a full range of liquidity management tools should be made available to fund managers for these to best manage their liquidity under market circumstances that may be very different. In a recent study undertaken together with the International Capital Market Association (ICMA)'s Asset Management and Investors Council (AMIC) on *Managing fund liquidity risk in Europe*, we recommended that ESMA encourage certain EU national competent authorities to consider broadening the range of available tools, thereby ultimately contributing to the management of liquidity risk, thus positively complementing the established legal frameworks. Our study also defined eight different types of liquidity management tools available to most managers, illustrating their benefits consistent with varying liquidity conditions, i.e. from the ordinary use of swing-pricing to the exceptional suspension of redemptions and creation of "side-pockets"¹⁴.

The fundamental purpose behind these measures, even before financial stability considerations, is the protection of the value of the shares/units of the remaining investors by avoiding that transaction costs related with meeting redemptions do not negatively affect those deciding to remain invested, nor undermine the chosen strategy that a portfolio is intended to deliver. For this reason, contrary to what has often been assumed in some quarters, portfolio managers typically do not sell a portfolio's most liquid assets to raise the cash required to honour redemptions, as it would inevitably dilute a chosen

¹⁴ Please refer to the joint EFAMA/AMIC study *Managing fund liquidity risk in Europe - an AMIC/EFAMA report of April 2016*; available at: http://www.efama.org/Publications/EFAMA_AMIC_Report_Managing_Fund_Liquidity_Risk_Europe.pdf

strategy. Rather, and only once available cash margins are low, consideration is given to sell a representative, risk-matched, “slice” of the portfolio. The size of such slice clearly depends on several factors that are both qualitative and quantitative by nature, involving a sound degree of judgement on behalf of several teams, including senior management.

Both of these aspects reflect an asset manager’s ability to manage liquidity as part of its fiduciary duties *vis-à-vis* investor clients. It would be wrong to assume – as at times intended in some regulatory narrative – that a portfolio manager’s duty is to always honour redemption requests readily. Discussions with portfolio managers and their internal teams confirm that selling assets in response to sudden market panics often may not serve the end-investor well, especially when market prices drop well below what the managers believe to be a security’s fair value. In such instances, waiting for asset prices to stabilise and “find a floor” would certainly avoid the liquidation of investors’ assets at a loss. Some of the available liquidity management tools serve their purpose by accommodating, when necessary, these precise decisions.

In sum, we wish to insist on the following key point: for investment managers, managing investors’ assets is not purely about being able to meet or not meet redemptions; rather, it is about doing so, while upholding their fiduciary duty to preserve the value of a portfolio even under abnormal market conditions. It is ultimately such considerations that create the reputation of a manager, setting able ones apart from the less able ones, with the former naturally attracting more client inflows.

Q6. What characteristics or metrics are most appropriate to determine if an asset is illiquid and should be subject to guidance related to open-ended funds’ investment in illiquid assets? Please also explain the rationales.

As liquidity is a multi-dimensional factor, there are several metrics to define whether an individual security is liquid or less liquid, depending on its nature and on the characteristics of its underlying market. We believe such metrics should not be prescriptive or be subject to more specific guidance for open-end funds. The degree of “liquidity” of a given security is in a constant state of flux, evolving with the broader market environment, and should therefore be left to the sole appreciation of the individual asset managers. We would also point out that were market supervisors to act on the basis of the results of a few summary liquidity metrics by imposing restrictions on fund activities, these would potentially interfere with the fiduciary duties of the asset management company *vis-à-vis* its investors.

Q7. Should all open-ended funds be expected to adhere to the recommendations and employ the same liquidity risk management tools, or should funds be allowed some discretion as to which ones they use? Please specify which measures and tools should be mandatory and which should be discretionary. Please explain the rationales.

EFAMA would indeed recommend that those investment companies managing open-end funds adhere to the proposed draft Recommendations in Section 2 of the consultative document, with the exception of draft Recommendation 9 for reasons already exposed.

In line with our response to Q.5 above, we further recommend that use of a broader set of liquidity risk management tools become an established practice within individual jurisdictions. Regulation should usefully create a framework for these tools to be used, and perhaps under certain

circumstances also require supervisory authorities to impose them¹⁵, but should definitely not limit their use or prescribe one over another. Important is to ensure that asset managers preserve their discretion by all means, considering the suspension of redemptions (and eventual recourse to “side-pockets”) as a measure of last resort.

Q8. Should authorities be able to direct the use of exceptional liquidity risk management tools in some circumstances? If so, please describe the types of circumstances when this would be appropriate and for which tools.

EFAMA would note that the intervention of market supervisors to direct the activation of specific liquidity management tools would be justified in truly exceptional cases and only where in the interest of the general public. In such circumstances, authorities would most likely opt for the suspension of dealings and/or the creation of “side-pockets”. In Europe, this possibility is expressly foreseen under Article 84(2) letter b) of the UCITS Directive, as a derogation to the general rule that a UCITS fund shall repurchase or redeem its units at the request of any unit-holder. We note, however, that even before market conditions become so dire as to require the intervention of the competent market supervisor as described above, an asset manager may actually activate the same measures – as the suspension of redemptions - *proprio motu*. This opportunity is also expressly foreseen under UCITS rules – see Article 84(2) letter a) of the Directive – and would be prompted more by the asset management company’s intent to protect existing share-holders (as explained in our response to Q.5 above), more than that of selfishly protecting its own franchise. We care to point out, on the basis of the arguments presented above, that the primary **competent securities market supervisor** would wield such powers in exceptional circumstances in light of its regulatory mandate, including the one for financial stability. Finally, it is a matter of fact that no evidence presently exists of episodes where the use of exceptional liquidity risk management tools has triggered or escalated a market event to become a full-blown systemic crisis. We reasonably think this will continue to be the case in the future.

Leverage within funds

EFAMA acknowledges the potential risks related to institutions making ample use of leverage. Among these, however, we do find that the use of leverage by a limited category of investment funds compared to leverage in the banking sector is grossly overstated. We therefore disagree with what appears to be a foregone conclusion to the FSB, i.e. that “(...) the use of leverage by funds can create and/or amplify risks to the global financial system through direct and indirect contagion channels”. Moreover, such claims are even less convincing in light of the FSB’s proper recognition of an array of counterparty risk mitigants referenced under Section 3.2 of the consultative document, ranging from enhanced regulatory reporting of leveraged exposures to greater investor disclosures, from collateralisation requirements and central clearing of standardised derivative contracts, to changes introduced by the Basel III framework to limit bank institutions’ exposures to investment funds. In this regard, we also note that the repeated reference in the consultative document (Sections 3.1 and 3.2)

¹⁵ For instance, under Article 84(2) of the UCITS Directive, by way of derogation from the obligation to repurchase or redeem units at the request of any unit-holder, a manager may - in accordance with the applicable national law, the fund rules or the instruments of incorporation of the investment company - temporarily suspend the repurchase or redemption of fund units. National Competent Authorities may also require the suspension of the repurchase or redemption of fund units in the interest of the unit-holders or of the public.

to the 1998 **Long-Term Capital Management (LTCM) L.P.** episode remains ambivalent: from one perspective, it is evoked as an example of how one individual asset management company can provoke or precipitate a crisis of systemic proportions; whereas from another perspective, the document's narrative appears to recognise that "(...) there have been significant changes in banking regulation since the failure of LTCM in 1998 that, among other things, help ensure that bank derivatives exposures to, and equity investments in, investment funds are well capitalised (...)" and that the Basel III framework will also reduce risks from interconnectedness between banks and funds". We encourage the FSB to consider the following limits in referring to the LTCM debacle as a pertinent example in the context of its consultation, i.e. the nature of the flagship Long-Term Capital Portfolio Fund was that of **an off-shore limited partnership**, open to selected investors who - essentially for tax purposes - did not invest directly, but only through *ad hoc* investment vehicles also established off-shore. It is difficult to understand how such example has been chosen to illustrate the risks in an otherwise heavily regulated industry like ours, especially in Europe. Furthermore, the market environment post-2008 is significantly different, as the FSB has also acknowledged in the consultative document, with tighter banking regulation ushered in by Basel III, the mandatory central clearing of most derivatives via CCPs, and with market actors in general less confident on the direction of the global economy as compared to the booming decade of the 1990s when LTCM opened its operations and later collapsed.

We also strongly disagree with the claim that domestic supervisory powers would only focus on breaches by individual funds, leaving the potential build-up of leverage across several funds or strategies to go unchecked. As an example, we find the following passage under Section 2.3 telling in this regard: "Pre-emptive supervisory intervention powers may also be limited in some jurisdictions and thus supervisors may not always be well positioned to take into account the build-up of sector-wide risks. Thus, there is a legitimate question around the effectiveness of existing mitigants to address stressed market conditions". In reality, under EU regulation - in particular the Alternative Investment Managers' (AIFM) Directive (2011/61/EU) - there are clear provisions for the national competent authorities to request that managers of alternative investment funds (AIFs) provide additional information to that already mandated on a periodic, as well as on an *ad hoc*, basis in relation to one or more funds managed. Such information shall be shared with the European Securities and Markets Authority (ESMA), where the latter would be able to impose additional disclosures in "exceptional circumstances and where required in order to ensure the stability and integrity of the financial system"¹⁶. That the AIFM Directive has an evident systemic risk dimension for preventive purposes is further testified by the fact the European Commission's original proposal in April 2009 delivers on the G20 recommendations to strengthen the global financial system¹⁷. Consequently, specific requirements are intended for competent authorities to share information with ESMA, with the European Systemic Risk Board (ESRB) and with the national competent authorities of other EU Member

¹⁶ Please refer to Article 24 of the directive, detailing all the required disclosures on the basis of which a domestic competent authority would be able to conclude on the systemic vs. non-systemic nature of any one or more funds registered in its jurisdiction.

¹⁷ Please refer to the *Declaration on Strengthening the Financial System* following the G20 London Summit in April 2009, where *inter alia* "(...) hedge funds or their managers will be registered and will be required to disclose appropriate information on an ongoing basis to supervisors or regulators, including on their leverage, necessary for assessment of the systemic risks that they pose individually or collectively. Where appropriate, registration should be subject to a minimum size. They will be subject to oversight to ensure that they have adequate risk management. We ask the FSB to develop mechanisms for cooperation and information sharing between relevant authorities in order to ensure that effective oversight is maintained where a fund is located in a different jurisdiction from the manager. (...)".

States, on those managers that manage “leveraged” AIFs (i.e. those funds that are leveraged on a “substantial basis” with a commitment net leverage factor above 3:1 relative to the fund’s NAV). Article 25(3) of the Directive (in conjunction with Article 112 of the implementing Regulation EU no. 231/2013) clearly empowers national competent authorities to set limits on the use of leverage by one or more managers to the extent “(...) the use of leverage by an AIFM or its interaction with a group of AIFMs or other financial institutions can contribute to the **build-up of systemic risk in the financial system or risks creating disorderly markets**” (emphasis added by EFAMA). Such decision must furthermore be notified to the ESMA, to the ESRB and eventually even to the competent authorities of the jurisdiction in which a fund is registered (i.e. where different from the jurisdiction in which the management company is established and authorised). ESMA may itself even recommend remedial action in the form of leverage limits to the national competent authority, immediately informing the ESRB and the European Commission thereafter¹⁸. The pre-emptive nature of these few provisions and intervention powers they consign to national supervisors, and exceptionally also to the ESMA, prove uncontroversially that – at least in Europe – market supervisors have a clear mandate to ensure financial stability.

Bearing these important clarifications in mind, we turn to analyse the proposed policy draft Recommendations intended to address the “residual risks” that, according to the FSB, would warrant a policy response, with particular regard to a consistent methodology to measure fund leverage both within and across jurisdictions, and to the availability of reliable data on leverage for supervisory authorities.

Q9. In developing leverage measures (Recommendation 10), are the principles listed above for IOSCO’s reference appropriate? Are there additional principles that should be considered?

EFAMA would firstly note that a “simple and consistent” measure could already be the definition of leverage as Total Exposure/NAV, where ideally the numerator should be a net figure (to account for offsetting netting and hedging transactions and net of any cash or cash equivalents). Such measure, however, is informative at the individual fund level only, or at most, when comparing funds that are very similar in terms of underlying, strategy and investor profile. Any further aggregation of fund leverage figures “(...) across jurisdictions and different types of funds (...)” would inevitably capture a fund universe that is plainly too large and too diverse to yield any appreciable and economically true estimate. Moreover, we do not support the FSB’s rationale for devising an aggregate leverage figure for it to be “comparable to those used by other types of financial entities”, including credit institutions, when – for the reasons explained above and in our previous responses – asset management is of a different nature and relies on a completely different business model relative to other financial actors.

In Europe, the EU Legislator has foreseen at least three methods to calculate a fund’s global exposure according to the UCITS and AIFM Directives, as further specified in related implementing regulations and via ESMA Guidelines: For UCITS, these are Value at Risk (VaR), either relative or absolute, or the commitment method. For AIFs, the AIFM Directive establishes that the global exposure for each AIF must be calculated and reported to authorities using both the commitment method (in common with UCITS) and the gross method. Both are specified in the relevant implementing Delegated Regulation 231/2013 of December 2012, accompanying the AIFM Directive.

¹⁸ Please refer to Article 25 of the directive, further detailing this pre-emptive procedure, as well as the institutional interplay between home and host authorities, the ESMA and the ESRB.

Each of these methods, depending on the type of investment vehicle and investment strategy, serves a specific purpose in that it allows managers to best discharge their fiduciary duties by keeping fund-specific exposures in check and in line with regulatory prescriptions. None of these methods has been intended to provide, once aggregated, a “top-down” leverage estimate for the purpose of monitoring financial stability. We would observe that the latter is a completely different exercise and one that will hardly yield a reliable figure given the diversity of investable assets, investor profiles and investment strategies. We therefore deem that a diversity of methods to calculate a fund’s global exposure is warranted by the sheer diversity of fund structures, as well as by the need to necessarily reflect information that is qualitative in nature, requiring a managers’ degree of judgement in light of prevailing market conditions and in the way these may impact the execution of a chosen investment policy and strategy. In sum, a “simple and consistent measure” of leverage would be extremely inaccurate as void of key qualitative information and subjective judgement, representing too broad a universe of fund vehicles to meet the ends intended by the FSB. Furthermore, a fund’s measure of leverage is calculated not solely on the basis of the results from the global exposure calculations cited above. These are in fact often integrated with stress-test results or information on the position limits of a fund at any one point in time, thereby complementing initial calculations. For this additional reason, no reliable leverage measure can be deemed “simple”.

Where derivatives are used to primarily either hedge exposures or provide access to asset classes more efficiently (i.e. without having to trade securities in the cash market), the quest for a “simple and consistent” measure is further discouraged by the need to account for derivative contracts, each with different and unique features, i.e. from the underlying values whose prices move continuously, to different contract tenors; from their cleared vs. non-cleared nature, to their specific collateralisation, to name only a few.

Alternatively, given the breadth and complexity of the issue at hand, EFAMA would like to propose that the final FSB Recommendations provide a mandate to IOSCO for global securities markets regulators to further study the feasibility of common leverage indicators for investment funds to be applied globally. In the meantime, it is important that leverage continue to be calculated on the basis of the existing methods, as in Europe and elsewhere, and that the monitoring of leverage for financial stability purposes be left within the statutory remit of the competent market supervisors. As repositories of fund-level regulatory filings, domestic supervisors would, as part of their statutory mandate, in our view be best able to monitor the build-up of any “excessive” leverage in specific corners of the market. Cooperation agreements between foreign supervisory authorities and eventual escalation procedures to notify supranational instances of looming macro-prudential risks, as in Europe, would be a natural part of this proposition. Relevant data on leverage for specific jurisdictions and for specific sectors of our industry (e.g. property funds in country “X”) could be opportunely aggregated by the national supervisor from a company’s regulatory filings and shared with those regional or global standard setters for the purpose of monitoring financial stability risks. In this regard, EFAMA would support the four principles¹⁹ highlighted in Section 3.4 and believe they could usefully underpin the aggregation efforts suggested above on the basis of IOSCO’s further work.

In this light, we therefore share and support draft Recommendation 11, whereby financial market supervisors act as the prime repositories for fund data on leverage and monitor the use of leverage by funds they directly supervise. As illustrated above, Article 25 of the AIFM Directive already foresees

¹⁹ These are (i) synthetic leverage, (ii) netting and hedging, (iii) directionality of positions, and (iv) model risk.

this. Based on existing reporting requirements (i.e. those under the revised ESMA template 2013/1359 for regulatory disclosures under the AIFM Directive, as presented in Annex III)²⁰, a more thorough elaboration of reported fund leverage data should be undertaken by national market supervisors, as well as its further aggregation based on existing domestic categorisations used by supervisors (or SROs, industry associations, etc.). Only then would such information be shared with those regional or international bodies for financial stability purposes, including IOSCO, in line with the draft Recommendation 12.

Q10. Should simple and consistent measure(s) of leverage in funds be developed before consideration of more risk-based measures, or would it be more appropriate to proceed in a different manner, e.g. should both types of measure be developed simultaneously?

Please refer to our response above.

Q11. Are there any particular simple and consistent measures of leverage or risk-based measures that IOSCO should consider?

Please refer to our response above.

Q12. What are the benefits and challenges associated with methodologies for measuring leverage that are currently in place in one or more jurisdictions?

We would refer the FSB to consider the various European approaches – as per the relevant EU legislation and regulation under the UCITS and AIFM Directive frameworks – to measure a fund’s “global exposure”. For UCITS, please refer to the Committee of European Securities Regulators’ (CESR) 2010 *Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS*. For AIFs, please refer to the relevant implementing delegated Regulation (No. 231/2013) to the AIFM Directive, in particular Articles 6 to 11.

Q13. Do you have any views on how IOSCO’s collection of national/regional aggregated data on leverage across its member jurisdictions should be structured (e.g. scope, frequency)?

EFAMA would propose that IOSCO take into account the current reporting contents and practices in key jurisdictions, identifying the scope and the frequency of the data to be received from national market supervisors, so as to avoid the costly duplication of regulatory filings for companies. For Europe, authorities should in particular leverage the information contained in the ESMA reporting template for regulatory disclosures under the AIFM Directive (please refer to Annex III).

Q14. Do the proposed policy recommendations on liquidity and leverage adequately address any interactions between leverage and liquidity risk? Should the policy recommendations be modified in any way to address these interactions? If so, in what ways should they be modified and why?

EFAMA would only add that any recourse to leverage at the individual fund level is naturally already factored into stress-tests funds in Europe are required to perform, whether they are structured as

²⁰ A relevant extract of the ESMA filing template is attached to this response as Annex III for information purposes.

UCITS or as AIFs. We would therefore suggest that the wording of draft Recommendation 6 be amended accordingly to reflect this as a good practice.

Operational risk and challenges in transferring investment mandates or client accounts

Section 4 of the consultative document is accurate in recognising that transferring investment mandates or client accounts between asset management companies has not given rise to financial stability concerns. Nor do we believe, as per our previous submissions to the FSB/IOSCO and in view of the very idiosyncratic nature of operation risks, that such transfers warrant further regulatory action.

The narrative in sub-Section 4.1 unfortunately suffers from the view that asset management companies of “sufficient scale and complexity” are monolithic entities, over-dependent on a handful of influential and reputable individuals, and whose “critical” services (e.g. information technology, pricing services, etc.) are in such wide demand enough to consolidate a company’s market share as the sole (i.e. a monopoly) or among the very few (i.e. an oligopoly) service providers in one or more relevant markets. We also critically reject, on the basis of the arguments illustrated above and underscoring once again that each fund is managed independently as an entity unto itself, that a manager suffering reputational damage “(...) in one business may suffer damage to its other business lines or business lines of its affiliates, potentially leading to redemptions across multiple investment vehicles or negative effects to other business functions”. Such hypotheses not only lack evidence, but are utterly unlikely to happen in practice. It is a matter of fact that the global asset management industry is very diversified, both for what concerns its core asset management function in the discharge of its fiduciary duties, as well as for ancillary services typically offered by myriads of competing external service providers (e.g. benchmark providers, trading platforms, performance and accounting programmes, order management systems, pricing vendors, providers of risk analytics, etc. to name only the most common). Such realities, we feel, are sufficient to largely dismiss the concerns around the provision of “critical services”²¹.

With regard to the three identified types of difficulties when transferring client accounts under stressed market conditions, we would observe the following:

- (i) Typically, the transfer of client assets does not occur, as these are held in a segregated account with, and overseen by, a global custodian (or “depository” to use the corresponding EU regulatory term), which under EU rules additionally exercises oversight over the actions of the asset management company to ensure that it complies with applicable regulation and the fund rules or instruments of incorporation. With regard to these assets, a manager may only issue trading instructions, where the depository has a contractual obligation only with the direct asset-owner, or the fund itself, thereby shielding assets and their owner from any operational or reputational fallout deriving from the asset management company. Where post-transfer the actual or selling of securities does occur, it is performed around the edges of the portfolio

²¹ For an overview of the many types of third-party vendors offering their services to asset management companies, please refer to a recent *Viewpoint* prepared by Blackrock, *The role of third party vendors in asset management*, as published in September 2016; available at: <http://www.blackrock.com/corporate/en-us/literature/whitepaper/viewpoint-role-of-third-party-vendors-asset-management-september-2016.pdf>

to reflect the newly-appointed managers' investment style, but not the chosen strategy. For more bespoke investment strategies, as typically those of hedge funds, fund liquidations are more common in concomitance with departures of large clients (also in view of fewer investors committing each larger amounts of capital (commonly together with that of the principal) to implement the underlying strategy. We would invite the FSB to refer back to our previous responses, as well as those of our Member national associations and corporates on this specific point, some offering a rich case history;

- (ii) Regarding the transfer of derivative contracts/positions and the associated legal challenges, we note that the concerns raised in the consultative document do not account for the advent of central clearing (as per the EU European Markets Infrastructure Regulation or "EMIR" of 2012) and deriving mandatory initial and variation margining requirements for most OTC derivative contracts to be phased-in in the course of 2017. Where OTC contracts are not centrally-cleared, given their very bespoke and non-standardised nature, the alternative would be for the counterparties to close-out the contract altogether, with an identical or similar position being re-established under a new contract under common ISDA terms. We believe that regulatory emphasis should focus on the systemic nature of critical market infrastructures like CCPs as the "spine" of the global financial system and potentially far more able to transmit systemic stresses instead of asset management companies and their funds;
- (iii) Experience would prove that transfer operations between asset managers are prudently not performed under abnormal market conditions as assumed in the consultative document. Any eventual sale of securities under such circumstance may be more arduous due to greater price volatility, it would incur transaction costs and translate into the temporary absence of investors from the market with foregone opportunities to investors if the relevant market rebounds;

We consider the consultative paper's account for the risk-mitigating factors – among which appropriate disaster recovery and business continuity plans - listed under sub-Section 4.2 to be sufficiently clear, precise and exhaustive, to dismiss further speculation as that in the final paragraphs of the following sub-Section 4.3.

Ultimately, EFAMA does not believe that the operational risks identified could ever become "systemic". On the important topic of fund liquidations, or terminations, and the related importance of back-up business continuity plans, we welcome the recent consultation of the IOSCO on *Good Practices for the Termination of Investment Funds*, as published in August 2016²². In our view, IOSCO has in this instance correctly appraised the termination of an investment fund as an investor protection rather than a source of potential systemic risks.

²² Please refer to the relevant IOSCO consultation report, published in August 2016; available at: <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD542.pdf>

Q15. The proposed recommendation to address the residual risks associated with operational risk and challenges in transferring investment mandates or client accounts would apply to asset managers that are large, complex, and/or provide critical services. Should the proposed recommendation apply more broadly (e.g. proportionally to all asset managers), or more narrowly as defined in Recommendation 13? If so, please explain the potential scope of application that you believe is appropriate and its rationales.

EFAMA broadly supports the draft Recommendation 13, agrees that it should apply more broadly to all asset managers (regardless of their size, complexity, etc.) and considers that comprehensive and robust risk-management frameworks are already in place as per existing European regulation. Business continuity and transition plans lie at the core of good corporate governance and we deem that asset management companies genuinely serving their clients' interest already implement such plans as a matter of principle and ahead of other considerations, e.g. the reputational fall-out from any operational disruption.

Securities lending activities of asset managers and funds

Indemnification, although we understand this to be a new area of interest, is far from becoming a "systemic" factor and appears devoid of any associated contagion risks, although may dent an individual firm's reputation to a certain, but in any case limited, extent. As the consultative document correctly points out, very few asset management companies provide agency-like securities lending services. Moreover, as the FSB duly recognises there are multiple levels of security built into an asset manager's agency lending business to avoid client indemnification. Among these, the over-collateralisation of the lender's exposure via the marking-to-market of the value of the securities on loan remains fundamental and is practiced widely. Were an indemnification obligation to be triggered, notwithstanding the aforementioned guarantees and despite the fact that asset management companies hold indemnity insurances for professional liability risks²³ (*inter alia*, against potential losses arising out of securities lending), the actual amount of the indemnification would not cover the full exposure of the loan. Rather, it would oblige the agent lender to only cover the shortfall between the value of the received collateral and the replacement cost of the lent instruments. We therefore deem balance sheet exposure for the asset management company in such rare events to be minimal and prudently backed either by reserves of unencumbered cash and/or by standing multi-year credit facilities, negotiated in advance and carrying charges. On the basis of these arguments and evidence, we disagree with the argument linking financial stability concerns to the extremely rare and limited event of client indemnifications. Additionally, we strongly disagree with the FSB's statement that "(...) the scale of exposures can be as large as that of some global systemically important banks (G-SIBs)" and wonder as to any evidence to substantiate it.

Finally, there are scarce foundations on which to base an argument around the supposed "migration" of agent securities lending activities away from prudentially regulated entities, like global custodians, into the non-bank sector. As per our earlier reply to the FSB, the relevant or even "dominant" market specialists of the securities lending business are global custodians constituting large "reservoirs" of

²³ For instance, please refer to Article 9(7) of the EU Alternative Investment Fund Managers (AIFM) Directive (2011/61/EU) of 8 June 2011.

lendable securities in view of their specific asset custody business. On the contrary, the few large asset management companies - acting as agent lenders and with sufficient scale to run lending programmes – would account for less than 20% of the global securities lending pool, roughly on par with direct lenders (i.e. global banks) which lend as principals.

Q16. In your view, what are the relevant information/data items authorities should monitor for financial stability purposes in relation to indemnifications provided by agent lenders/asset managers to clients in relation to their securities lending activities?

On the basis of the arguments developed above, there are no systemic risks associated with indemnification practices and warranting the transmission of data to supervisory authorities for monitoring purposes beyond those already included in the regulatory disclosures.

Q17. Should the proposed recommendation be modified in any way to address residual risks related to indemnifications? For example, should it be more specific with respect to actions to be taken by authorities (e.g. identifying specific means for covering potential credit losses) or more general (e.g. leaving to authorities to determine the nature of appropriate action rather than specifying coverage of potential credit losses)?

Please refer to our response to Q.16 above.

Brussels, 21 September 2016

[15-4064]

Annex I – Managing fund liquidity risk in Europe: The current regulation

The sections below outline the existing regulatory requirements in EU legislation across the AIFM and UCITS regimes, both evidence of far-reaching legal requirements regarding fund liquidity, which have been successfully implemented.

The AIFM Directive

To date, the liquidity risk management requirements of the Level 1 AIFM Directive (2011/61/EU) and its implementing acts have proven their merit since their implementation three years ago, in particular in the context of several significant market dislocations which have occurred since then. Such requirements are specifically aimed at ensuring appropriate liquidity management for alternative investment portfolios containing less liquid assets.

General permanent and independent risk management function

According to Article 39 of the delegated Regulation (No. 231/2013) to the AIFM Directive, implementing Article 15 of the Level 1 text dedicated to Risk Management, an alternative investment fund management (AIFM) company shall establish and maintain a permanent risk management function. This function will have to, firstly, implement effective risk management policies and procedures in order to identify, measure, manage and monitor on an ongoing basis all risks (including liquidity-risk) relevant to each AIF's investment strategy, and secondly, ensure that the risk profile of the AIF disclosed to investors is consistent with the risk limits that have been set in accordance with Article 44 of the Regulation (see *infra*). Moreover, this function must comply with the obligation to monitor compliance with the above risk limits, notifying the management company's management and/or supervisory function when the AIF no longer adheres (or risks no longer adhering) to such limits. Regular updates to the management and/or supervisory function are also required.

Specific liquidity risk management requirements

In addition to the general risk management requirements mentioned above, the AIFM Directive provides specifically for a robust liquidity management framework through its Article 16, notably through the first paragraph which states that AIFMs shall for each fund managed which is not a closed-end fund employ an appropriate liquidity management system, including procedures to monitor the liquidity risk of the AIF and to ensure that the liquidity profile of the investments of the AIF complies with its underlying obligations. The following sub-paragraph reinforces such requirement by also mandating that the companies regularly conduct stress-tests, under normal and exceptional liquidity conditions (...) to assess and monitor the liquidity profile and risk of the AIFs. The second paragraph adds that the companies must also ensure that the AIFs' investment strategy, their liquidity profile and their redemption policy are consistent.

The accompanying delegated Regulation (EU) No. 231/2013 – under Article 46 thereof - further consolidates these provisions by requiring that managers demonstrate to the National Competent Authorities of their home Member State that an appropriate liquidity management system and effective procedures referred to in Article 16 of the Directive are in place, and that these are calibrated to the investment strategy, the liquidity profile and the redemption policy of each AIF.

Article 44 of the Regulation introduces quantitative and/or qualitative risk limits for each managed AIF, taking into account all relevant risks. These are to at least cover the following risks: (i) market risks, (ii) credit risks, (iii) liquidity risks, (iv) counterparty risks, and (v) operational risks. When setting these, the management company shall take into account the individual strategies and assets invested in for each AIF it manages, as well as the national rules applicable to each of these.

Specific controls to monitor performance of illiquid assets

Article 47(1) of the delegated Regulation lays out the specific details of the liquidity management system and procedures for each AIF as follows:

- a) *The AIFM maintains a level of liquidity in the AIF appropriate to its underlying obligations, based on an assessment of the relative liquidity of the AIF's assets in the market, taking account of the time required for liquidation and the price or value at which those assets can be liquidated, and their sensitivity to other market risks or factors;*
- b) *The AIFM monitors the liquidity profile of the AIF's portfolio of assets, having regard to the marginal contribution of individual assets which may have a material impact on liquidity, and the material liabilities and commitments, contingent or otherwise, which the AIF may have in relation to its underlying obligations. For these purposes the AIFM shall take into account the profile of the investor base of the AIF, including the type of investors, the relative size of investments and the redemption terms to which these investments are subject;*
- c) *The AIFM, where the AIF invests in other collective investment undertakings, monitors the approach adopted by the managers of those other collective investment undertakings to the management of liquidity, including through conducting periodic reviews to monitor changes to the redemption provisions of the underlying collective investment undertakings in which the AIF invests. (...);*
- d) *The AIFM implements and maintains appropriate liquidity measurement arrangements and procedures to assess the quantitative and qualitative risks of positions and of intended investments which have a material impact on the liquidity profile of the portfolio of the AIF's assets to enable their effects on the overall liquidity profile to be appropriately measured. The procedures employed shall ensure that the AIFM has the appropriate knowledge and understanding of the liquidity of the assets in which the AIF has invested or intends to invest including, where applicable, the trading volume and sensitivity of prices and, as the case may be, or spreads of individual assets in normal and exceptional liquidity conditions;*
- e) *The AIFM considers and puts into effect the tools and arrangements, including special arrangements, necessary to manage the liquidity risk of each AIF under its management. The AIFM shall identify the types of circumstances where these tools and arrangements may be used in both normal and exceptional circumstances, taking into account the fair treatment of all AIF investors in relation to each AIF under management. (...).*

Such requirements are complemented by the obligation for the asset management company to document its liquidity management policies and procedures, as well as review them on at least an annual basis. Appropriate escalation measures have to be necessarily in-built to the above systems and procedures to address anticipated or actual liquidity shortages or other distressed situations of the AIF.

Article 48(1) of the Regulation requires the management company to monitor compliance with the limits of Article 44 and, where these are exceeded or likely to be exceeded, it is to determine a required (or necessary) course of action. In doing so, a manager should consider its liquidity management policies and procedures, the liquidity profile of the AIF's assets and the effect of "atypical" levels of redemption requests.

Stress-testing

Paragraph 2 of Article 48 of the delegated Regulation mandates the conduct of stress-tests, both under normal and exceptional market conditions. Their design is specified as follows, with stress-tests to:

- a) *Be conducted on the basis of reliable and up-to-date information in quantitative terms or, where this is not appropriate, in qualitative terms;*
- b) *Where appropriate, simulate a shortage of liquidity of the assets in the AIF and atypical redemption requests;*
- c) *Cover market risks and any resulting impact, including on margin calls, collateral requirements or credit lines;*
- d) *Account for valuation sensitivities under stressed conditions;*
- e) *Be conducted at a frequency which is appropriate to the nature of the AIF, taking in to account the investment strategy, liquidity profile, type of investor and redemption policy of the AIF, and at least once a year.*

Finally, Article 49 of the delegated Regulation foresees the conditions for a fundamental alignment between the investment strategy, liquidity profile and redemption policy of each AIF managed. Such condition is satisfied when investors have the ability to redeem their investments in a manner consistent with the fair treatment of all AIF investors and in accordance with the AIF's redemption policy and its obligations.

The UCITS Directive

Pre-dating the AIFM Directive by over two decades, the UCITS Directive (2009/65/EC) of 1985 (regularly updated since then) is a unique investment product legislation - justified by the retail nature of the UCITS pan-European "passporting". It is characterised by the offer to investors of on-demand liquidity and built around a significant and prescriptive regulatory framework. For the informative purposes of this paper, we wish to stress that the liquidity requirements illustrated above in reality already represent a second "line of defence" against liquidity risk. The first and most important element that has successfully guaranteed the liquidity of the UCITS product in line with its Article 84(1) obligation, from its inception in 1985 until this day, are the specific portfolio diversification requirements under Article 52 et seq. of the Directive, as reinforced by a list of eligible and non-eligible assets under the previous Article 50.

Succinctly, UCITS portfolio diversification is based on the so-called "5-10-40 Rule", set out in Article 52(1) and (2). Accordingly, a UCITS shall invest no more than 5 % of its assets in transferable securities or money market instruments issued by the same body. The risk exposure to a

counterparty of the UCITS in an OTC derivative transaction shall not exceed 10 % of its assets when the counterparty is a credit institution (or 5 % of its assets in other cases). The above 5 % limit may be raised to a maximum of 10 %, albeit the total value of the transferable securities and the money market instruments held by the UCITS in the issuing bodies in each of which it invests more than 5 % of its assets shall not exceed 40 % of the value of its assets. Notwithstanding these individual limits, a UCITS shall not combine, where this would lead to investment of more than 20 % of its assets in a single body, (i) investments in transferable securities or money market instruments issued by that body, (ii) deposits made with that body, or (iii) exposures arising from OTC derivative transactions undertaken with that body as a counterparty. Articles 53 to 57 allow for adjustments to these limits and prescribe additional ones that we do not address here as they would go beyond the specific scope of this report.

As above with the AIFM Directive, we present the corresponding liquidity risk management requirements for UCITS management companies in the following sub-sections.

General permanent and independent risk management function

Article 51(1) of the Level 1 Directive provides that a UCITS management company shall employ a risk-management process which enables it to monitor and measure the risk of the positions and their contribution to the overall risk profile of the UCITS portfolio at any time. Such a process comprises procedures which enable the management company to assess the UCITS' exposure to all material risks including market risks, liquidity risks, counterparty risks and operational risks.

The implementing Directive 2010/43/EU further specifies – under Article 9(2) letter f) - that the senior management of the management company approve and review for each managed UCITS and on a periodic basis the risk management policy, together with the arrangements, processes and techniques for its implementation. The following Article 12(2) requires the permanent risk management function to be hierarchically and functionally independent from other operating units of the management company. Inter alia, it shall additionally implement the risk management policy and procedures; ensure compliance with the UCITS' risk limits, including statutory limits concerning global exposure and counterparty risk in accordance with the relevant provisions of the main directive and more recent 2012 ESMA *Guidelines* (see *infra*); advise senior management and/or the supervisory function with regard to the risk profile for each managed UCITS and its consistency with current risk levels, as well as to the adequacy of the risk management process (indicating in particular whether appropriate remedial measures have been taken in the event of eventual deficiencies); and provide regular reports to senior management outlining the current level of risk incurred by each managed UCITS and any actual or foreseeable breaches of their limits.

Specific liquidity risk management requirements

Under the Level 1 Directive, liquidity risk management requirements to which UCITS funds and their management companies are subject stem from the general obligation of Article 84(1), whereby a UCITS shall repurchase or redeem its units at the request of any unit-holder. By way of derogation, the following paragraph 2 further provides that a UCITS may, in accordance with the applicable national law, the fund rules or the instruments of incorporation of the investment company, temporarily suspend the repurchase or redemption of its units and its National Competent Authorities may require the suspension of the repurchase or redemption of units in the interest of the unit-holders or of the public. Moreover, the previous Article 76 requires that a UCITS make

public in an appropriate manner the issue, sale, repurchase or redemption price of its units each time it issues, sells, repurchases or redeems them, and at least twice a month.

More detailed obligations derive from the implementing Directive 2010/43/EU, whereby Article 23(4) obliges UCITS management companies in implementing their risk management policy to formulate forecasts and perform analyses concerning the investment's contribution to the UCITS portfolio composition, liquidity and risk and reward profile prior to their investment. In terms of risk-management policy, the following Article 38(1) prescribes procedures as are necessary to enable the management company to assess for each UCITS it manages the exposure of that UCITS to market, liquidity and counterparty risks, and the exposure of the UCITS to all other risks, including operational risks, which may be material for each UCITS it manages. According to the following paragraph 2, such risk-management policy and resulting activity are to be reported to the UCITS board of directors, senior management, as well as to eventual internal supervisory function. Any material changes to the risk management process are to be reported to the National Competent Authority.

Specific controls to monitor performance of illiquid assets

Article 39(1) of the implementing Directive 2010/43/EU obliges UCITS management companies to assess, monitor and periodically review the effectiveness of their risk management policy, their degree of compliance with it and the adequacy of measures taken to address any deficiencies in the risk management process. Moreover, the companies are to notify to National Competent Authorities any material changes to their risk management process and ensure that the above requirements are subject to regulatory review on an on-going basis even after authorisation is granted.

According to the following Article 40(3) of the implementing Directive 2010/43/EU, UCITS are to employ an appropriate liquidity risk management process in order to ensure that each UCITS they manage is able to comply at any time with allowing investors to redeem their units on demand. Paragraph 4 adds that UCITS management companies are to ensure that for each UCITS they manage the liquidity profile of the investments of the UCITS is appropriate to the redemption policy laid down in the fund rules or the instruments of incorporation or the prospectus.

Complementary guidelines that address liquidity are also to be found in ESMA's 2012 *Guidelines on ETFs and other UCITS issues* (as revised in 2014), albeit these address the liquidity of collateral received in the context of efficient portfolio management (EPM) transactions and/or OTC derivative ones. For instance, under paragraph 43 letter a) of the *Guidelines*, the liquidity of received collateral – other than cash – is to be ensured by trading it on a regulated market or multilateral trading facility, with transparent pricing, in order for it to be sold rapidly and at a price that is close to pre-sale valuation. Paragraph 45 recommends that a UCITS receiving collateral for over 30% of its NAV conduct regular stress-tests, to be carried out under normal and exceptional liquidity conditions. Such tests should at least specify a) the design of stress-test scenario analysis including calibration, certification and a sensitivity analysis, b) the empirical approach to impact assessment, including back-testing of liquidity risk estimates, c) the reporting frequency and limit/loss tolerance threshold/s, and d) mitigating actions to reduce losses (including a haircut policy and gap risk protection).

Stress-testing

Although not expressly in the text of the Level 1 Directive, stress-tests have become a core requirement even for UCITS funds, following the implementing Directive 2010/43/EU and the Committee of European Securities Regulators' (CESR) 2010 *Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS*.

Implementing Directive, Article 40(2) letters b) and c) prescribe that for each UCITS they manage, companies must conduct periodic back-tests in order to review the validity of risk measurement arrangements (including model-based forecasts and estimates), as well as periodic stress-tests and scenario analyses to address risks arising from potential changes in market conditions that might adversely impact the value of the UCITS portfolio.

In addition, Article 40(3), Member States shall ensure that management companies employ an appropriate liquidity risk management process. In particular, Article 40(3) requires that where appropriate, management companies shall conduct stress tests which enable assessment of the liquidity risk of the UCITS under exceptional circumstances.

With regard to the *Guidelines*, these specify that where the Value at Risk (VaR) approach is used to calculate global exposure, each UCITS should adopt a rigorous and comprehensive stress-testing programme in accordance with qualitative and quantitative requirements. Such programme should be designed to measure any potential major depreciation of the UCITS value as a result of unexpected changes in the relevant market parameters and correlation factors. Conversely, where appropriate, it should also measure changes to these parameters and factors, which could result in major depreciation of the UCITS value. Such tests should be adequately integrated into the UCITS risk management process and results considered when making investment decisions on behalf of investors in the UCITS, i.e. results should be monitored and analysed by the responsible risk management function and submitted for review to the senior management. Where particular vulnerabilities are revealed, prompt steps/corrective actions should be taken (e.g. hedging or a reduction in the relevant exposure).

The accompanying quantitative requirements of the *Guidelines* (Box 20) specify that tests should cover all risks which affect the value or the fluctuations in value of the UCITS portfolio to a significant degree. In particular, those risks which are not fully captured by the VaR model used. In terms of focus, the stress-tests should address those risks which, though not significant in normal circumstances, are likely to be significant in stress scenarios (e.g. unusual correlations, spikes in market illiquidity, behaviour of complex structured products, etc.). Finally, the accompanying qualitative requirements (Box 21) prescribe that stress-tests be carried out on a regular basis at least once a month, or earlier whenever a change in the value or the composition of a UCITS or a change in market conditions makes it likely that the test results will differ significantly from the ones performed previously. Ultimately, the management company should implement clear procedures relating to the design and ongoing adaptation of the stress-tests.

Annex II – Mandatory EU disclosures to regulators and investors on AIF/UCITS fund liquidity profile and risks

Alternative Investment Funds (AIFs)

Disclosures to regulators

In terms of regulatory disclosures, Article 24(1) of the EU AIFM Directive (2001/61/EU) provides that a management company must regularly report to the National Competent Authorities of its home Member State to inform them of the principal markets and instruments in which it trades for the AIFs it manages, including a break-down of financial instruments and other assets, the AIF's investment strategies and their geographical and sectoral investment focus. Information shall include the mainly traded instruments, the principal exposures and most important concentrations for each of the AIFs it manages.

The following paragraph mandates that details concerning the liquidity profile of each AIF, including the results of the stress-tests performed, be shared with the National Competent Authorities. More specifically, the management company shall for each managed AIF disclose to the Authorities:

- (a) The percentage of the AIF's assets which are subject to special arrangements arising from their illiquid nature;*
- (b) Any new arrangements for managing the liquidity of the AIF;*
- (c) The current risk profile of the AIF and the risk management systems employed by the AIFM to manage the market risk, liquidity risk, counterparty risk and other risks including operational risk;*
- (d) Information on the main categories of assets in which the AIF invested; and*
- (e) The results of the stress-tests performed (...).*

For those AIFs that employ leverage on a substantial basis – defined as a leverage factor above 3:1 relative to NAV – additional reporting requirements are triggered, including information on the overall level of leverage employed by each AIF managed, a break-down between leverage arising from the borrowing of cash or securities vs. leverage embedded in financial derivatives, as well as the extent to which the AIF's assets have been reused under leveraging arrangements to the National Competent Authorities. Such information shall include the identity of the five largest sources of borrowed cash or securities for each of the AIFs and the amounts of leverage received from each of those sources for each AIF.

Finally, where necessary for the effective monitoring of systemic risk, the National Competent Authorities may require additional information on a periodic, as well as on an ad hoc basis, and inform ESMA accordingly. The AIFM Directive provides for AIFs and their managers to report this data to National Competent Authorities for onward transmission to ESMA and the ESRB. Once these onwards transmission channels are fully operational, these bodies will be able to review and analyse the enhanced data sets for the purpose of improving their risk assessments of European markets.

Disclosures to investors

As a complement to the in-depth regulatory disclosures to their competent authorities as described above, AIF management companies must also comply with an extensive list of investor disclosures. As per Article 23 of the Directive, these include inter alia a description of the investment strategy and objectives of the AIF (including specific information for AIF master-feeder structures), a description of the types of assets in which the AIF may invest, the techniques it may employ and all associated risks and any applicable investment restrictions. On leverage, the circumstances in which the AIF may have recourse to leverage shall be communicated, as the types and sources of leverage permitted up to a maximum level and the associated risks, along with any restrictions on its use. Collateral and asset reuse arrangements should also be indicated, including any specific treatment for assets of a relatively illiquid nature. Article 108(2), letter a) of the delegated Regulation No. 231/2013 substantiates these information requirements vis-à-vis illiquid assets by demanding that investors be offered an overview of any special arrangements in place including whether they relate to side pockets, gates or other similar arrangements, the valuation methodology applied to assets which are subject to such arrangements and how management and performance fees apply to these specific assets. This is to be accompanied by a description of the procedures by which the AIF may change its investment strategy or investment policy.

Pertinent to liquidity risk management is the description of the AIF's related risk management procedures and systems, including information on redemption rights both in normal and in exceptional circumstances, as well as how the management company plans to ensure the fair treatment of all investors. In this regard, investors may find information on notice periods in relation to redemptions, details of lock-up periods, an indication of circumstances in which normal redemption mechanisms might not apply or may be suspended, and details of any measure that may be considered by the governing body, such as gates or side pockets, as they have an impact on the specific redemption rights of investors in the particular AIF.

The above information shall be disclosed as part of the AIF's periodic reporting to investors, as required by the AIF's rules or instruments of incorporation or at the same time as the prospectus and offering document and — as a minimum — at the same time as the annual report is made available or made public.

UCITS Funds

Prior to the specific liquidity-management requirements mandated under the EU UCITS Directive (2009/65/EC), the first and most important element that has successfully guaranteed the liquidity of a UCITS fund in line with their obligation to *repurchase or redeem its units at the request of any unit-holder*, are the specific portfolio diversification requirements (under Article 52 *et seq.*) of the Directive, as reinforced by a list of eligible and non-eligible assets (under Article 50 thereof).

Disclosures to regulators

UCITS management companies are to notify to National Competent Authorities any material changes to their risk management process and ensure that their specific liquidity risk management requirements are subject to regulatory review on an on-going basis even after authorisation is

granted. In line with their obligations, especially those deriving from the implementing Directive 2010/43/EU, UCITS management companies would need to report details on to how they are implementing their internal risk management policy to, for instance, assess for each UCITS they manages the exposure of that UCITS to market, liquidity and counterparty risks, and the exposure of the UCITS to all other risks, including operational risks, which may be material for other UCITS they manage. Regulatory disclosures upon authorisation and on a periodic, ongoing basis in the event of material changes may also include the results of stress-tests, calibrated and performed to assess the liquidity risk of the UCITS under exceptional circumstances²⁴.

Disclosures to investors

As for AIF management companies, apart from the regulatory disclosures, Chapter IX of the UCITS Directive provides for an extensive list of necessary disclosures to investors to be inserted in fund prospectuses, yearly and half-yearly reports, as well as in key investor information documents. These are complemented by the investor transparency requirements stemming from the 2010 CESR *Guidelines* insofar as exposure-related information in the fund prospectuses and in the annual reports are concerned. These disclosures are deemed largely sufficient for investors of varying degrees of financial literacy to form a summary, yet objective, view of the liquidity risks relative to their investment.

²⁴ For further insights into the design of UCITS stress-tests, please refer to the Committee of European Securities Regulators' (CESR) 2010 *Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS*.

Annex III – Relevant extract from the ESMA AIFM Directive’s reporting template (2013/1359) for regulatory disclosures under Article 24(2) of the Directive

3. Liquidity Profile	
Portfolio Liquidity Profile	
Percentage of portfolio capable of being liquidated within:	
1 day or less	
2 – 7 days	
8 – 30 days	
31 - 90 days	
91 - 180 days	
181 – 365 days	
more than 365 days	
Value of unencumbered cash	
Investor Liquidity Profile	
Percentage of investor equity that can be redeemed within (as % of AIF’s NAV) :	
1 day or less	
2 – 7 days	
8 – 30 days	
31 - 90 days	
91 - 180 days	
181 – 365 days	
more than 365 days	
Investor redemptions	
a) Does the AIF provide investors with withdrawal / redemption rights in the ordinary course?	
b) What is the frequency of investor redemptions (if multiple classes of shares or units, report for the largest share class by NAV) [Select one] <i>Daily</i> <i>Weekly</i> <i>Fortnightly</i> <i>Monthly</i> <i>Quarterly</i> <i>Half-yearly</i> <i>Yearly</i> <i>Other</i> <i>None</i>	
c) What is the notice period required by investors for redemptions in days <i>(report asset weighted notice period if multiple classes or shares or units)</i>	
d) What is the investor ‘lock-up’ period in days (report asset weighted notice period if multiple classes or shares or units)	

Special arrangements and preferential treatment		
a) As at the reporting date, what percentage of the AIFs NAV is subject to the following arrangements:		
Side pockets (in %)		
Gates (in %)		
Suspension of dealing (in %)		
Other arrangements type		
Other arrangements for managing illiquid assets (<i>in %</i>)		
b) Indicate the percentage of net asset value of AIF's assets that are currently subject to the special arrangements arising from their illiquid nature under Article 23 (4) (a) of the AIFMD including those in items 197 to 201?		
Special arrangements as a % of NAV		
c) Are there any investors who obtain preferential treatment or the right to preferential treatment (e.g. through a side letter) and therefore are subject to disclosure to the investors in the AIF in accordance with Article 23(1)(j) of the AIFMD?		
d) If 'yes' to letter c) then please indicate all relevant preferential treatment:		
Concerning different disclosure/reporting to investors		
Concerning different investor liquidity terms		
Concerning different fee terms for investors		
Preferential treatment other than that specified above		
Breakdown of the ownership of units in the AIF by investor group		
<i>as % of NAV of AIF assets; look-through to the beneficial owners where known or possible</i>		
<i>For each investor group type:</i>		
	208	209
	Investor Type	Group Investor group NAV rate
Non-financial corporations (<i>leave blank if not applicable</i>)	NFCO	
Banks (<i>leave blank if not applicable</i>)	BANK	
Other collective investment undertaking (e.g. fund of funds or master) (<i>leave blank if not applicable</i>)	OCIU	
Other financial institutions (<i>leave blank if not applicable</i>)	OFIN	
Insurance corporations (<i>leave blank if not applicable</i>)	INSC	
Pension funds (<i>leave blank if not applicable</i>)	PFND	
General government (<i>leave blank if not applicable</i>)	GENG	
Households (<i>leave blank if not applicable</i>)	HHLD	
Unknown (<i>leave blank if not applicable</i>)	UNKN	
None (<i>leave blank if not applicable</i>)	NONE	
Financing liquidity		
a) Provide the aggregate amount of borrowing and cash financing available to the AIF (including all drawn and undrawn, committed and uncommitted lines of credit as well as any term financing)		
b) Divide the amount reported in letter a) among the periods specified below depending on the longest period for which the creditor is contractually committed to provide such financing:		

1 day or less	
2 – 7 days	
8 – 30 days	
31 - 90 days	
91 - 180 days	
181 – 365 days	
more than 365 days	