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JITA Comments on *Addressing Structural Vulnerabilities from Liquidity Mismatch in Open-Ended Funds – Revisions to the FSB's 2017 Policy Recommendations: Consultation report*

The Investment Trusts Association, Japan (JITA) appreciates the opportunity to express our opinions concerning the consultation report, *Addressing Structural Vulnerabilities from Liquidity Mismatch in Open-Ended Funds – Revisions to the FSB's 2017 Policy Recommendations: Consultation report*. As the nation's self-regulatory organization for OEF managers, JITA requests your consideration of the following opinions in relation to this consultation report:

1. Introduction

- The important social mission of investment trusts is to diversify risk while meeting investor needs for medium- to long-term asset formation. In light of such asset formation needs of investors, it is important to manage investment trusts as effectively as possible. At the same time, risk management to ensure a certain degree of liquidity while also ensuring fairness between beneficiaries is extremely important to meet investor needs for cash conversion.

- Action has already been taken in Japan in accordance with the FSB's *Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities*, published in January 2017. Specifically, to address vulnerabilities from liquidity mismatch, the Japanese financial authorities have revised regulations governing conduct for liquidity risk management of publicly offered investment trusts (promulgation on June 4, 2020, of the amended Cabinet Office Order on Financial Instruments Business, which went into force on January 1, 2022); and JITA has also established the liquidity risk management provisions of its self-regulatory rules (announcement on June 11, 2020, of revisions to its relevant rules, which have been enforced since January 1, 2022). In compliance with these laws, self-regulatory rules, company regulations, and so forth, OEF managers in Japan have been dealing with fund subscriptions and redemptions on a daily basis while paying due attention to the liquidity of their asset holdings as part of the process from the time of OEFs structuring to management, through monitoring and building a management approach that adequately considers the safety and cash convertibility of OEFs.

2. Structural Liquidity Mismatch (Recommendation 3, and Questions 2–5)

- In regard to the liquidity risk management of OEFs, particularly the mechanism to ensure the consistency of the redemption frequency of investors and the liquidity of asset holdings, we endorse the FSB's awareness of the issues concerning the importance of an OEF managers incorporating an appropriate mechanism into the scheme at the time of structuring in light of the anticipated liquidity of the OEF's entire portfolio and managing the mechanism on an ongoing basis.

- Nevertheless, we object to the FSB's proposed bucketing approach for the reasons stated below.
  - (i) First, what is important is to offer multiple options for precise, feasible, and economically rational liquidity management measures and tools in light of the vulnerabilities of existing OEFs in individual jurisdictions so that OEF managers can incorporate appropriate liquidity risk management into individual OEF schemes. The FSB's bucketing approach—which proposes classifying OEFs according to the liquidity of their asset holdings and then requiring OEFs allocating a certain proportion or more of their assets to less liquid assets to introduce uniform anti-dilution liquidity management tools (LMTs)—will be an obstacle for the aforementioned proactive initiatives taken by OEFs and their managers.

  - (ii) The definition of *liquidity*—liquid, illiquid, and less liquid—used in the bucketing approach lacks clear criteria and requirements. Even if the financial authorities in each jurisdiction were to define this term, the constant day-to-day changes in asset liquidity due to various factors such as the market environment will make it extremely difficult to set a uniform definition.

  - (iii) Moreover, in regard to setting thresholds for liquidity-based OEF categories (e.g., more than 50% in less liquid assets), since the liquidity and price of asset holdings are constantly changing on a day-to-day basis, we can easily imagine the extreme practical difficulties of linking threshold management to the implementation of uniform anti-dilution LMTs. (In that case, it would also be conceivable to employ methods for restricting liquidity for investors, including suspension of redemptions and setting of notice periods, as options.)

- In Japan, a system is in place that allows for, at the design and structuring stage of OEFs, the flexible setting of appropriate investor subscription and redemption frequencies after carefully considering the consistency between the liquidity of the investment assets and delivery to investors in light of factors such as the liquidity of asset holdings and the management method of the OEF and the anticipated characteristics of investors. The set frequency, etc. are stipulated in the investment trust contract, and also disclosed to investors in advance.

- In addition, as aforementioned, JITA's Rules on Management of Investment Trusts, Etc., part of the self-regulatory rules in Japan, have a provision titled "Development of Liquidity Risk Management Systems." This provision, Article 2-4 of the Rules, requires OEF managers to take actions including the following: establish the liquidity risk management process; evaluate liquidity risk; classify asset holdings into four categories according to the number of days within which they can be sold and other criteria; daily monitor the liquidity risk of the entire OEFs based on those categories; take appropriate measures in accordance with the predetermined internal rules if the holding ratio exceeds the set upper limit or falls short of the set lower limit; formulate contingency plans; periodically review the liquidity risk management process; be supervised by the board of directors and other organs: and provide disclosure to investors.

- In Japan, the above types of measures are already in place for liquidity risk management of OEFs, and the managers conduct appropriate day-to-day management of the liquidity risk of their OEFs. We would also like to mention that, even during the 2020 market turmoil and prior periods of stress, there were no large-scale redemptions of OEFs and similar events in Japan that would have caused financial instability.

3. Liquidity Management Tools (Recommendations 4 and 5, and Questions 7 and 9)

- In regard to the LMTs prepared for each jurisdiction, it is important to ascertain that those LMTs accurately address the market characteristics and OEF vulnerabilities in each jurisdiction, and to allow and provide multiple options, including anti-dilution LMTs, so that managers can adopt appropriate tools for the respective characteristics of various OEFs, rather than mandating the use of a uniform tool.

- In Japan, a system has long been in place where fees are charged at the time of subscription or redemption (or both) in light of the characteristics of each OEF. This is a mechanism that imposes the costs that arise from transacting asset holdings onto the subscribing or redeeming investors through a levy in an amount calculated by multiplying the net asset value (NAV) per share by a certain percentage, whether in normal or stressed market conditions. This system serves to mitigate first-mover advantage to a certain extent, and is also effective from the perspective of preventing the dilution of OEFs.

- The anti-dilution LMTs listed in the International Organization of Securities Commissions (IOSCO) Consultation Report, *Anti-Dilution Liquidity Management Tools – Guidance for*

Effective Implementation of the Recommendations for Liquidity Risk Management for Collective Investment Schemes, published in response to the proposed revisions to the FSB's 2017 Policy Recommendations, have been developed through years of improvements in the OEF system in individual jurisdictions, reflecting their own experiences and circumstances. When considering their introduction in each jurisdiction, careful discussion about the necessity and the method of establishing such tools is required after clarifying the current circumstances, and specifically, how the liquidity mismatch could materialize, and whether this may not be covered.

- When considering the introduction of additional tools, it is likely that various issues and costs will arise due, for example, to revisions to laws, regulations, and rules and changes to practical infrastructure. Therefore, the decision should be made after undertaking a policy assessment, such as the assessment of the jurisdictional circumstances and the relationship with the additional tools and the already introduced tools, measurement of the costs and benefits related to the introduction of additional tools, and the substantial effect on investors.

- We must say that introducing additional anti-dilution LMTs in Japan will be extremely difficult in practice due to the following factors: the inability for OEF managers to grasp the total costs that arise from subscriptions and redemptions; the time constraints given the extremely short period of time between the deadline for applying for subscriptions and redemptions and the time for calculating the NAV per share; and the prospect that system development and other costs required for introduction become enormous, with such burden ultimately passed onto investors.

- In the event that additional tools are still deemed necessary to be introduced after conducting such assessment, developments will need to be made to business infrastructure for the entire investment chain of OEFs, including managers; at the same time, consideration will need to be given to ensure that introducing the additional tools does not place considerable undue burden on the participants in the investment chain.

4. Liquidity Management Tools (Recommendation 8 and Question 10)

- Quantity-based LMTs should, if necessary, be incorporated as a matter of course by the OEF managers when structuring the scheme, in light of characteristics of the investment assets. Multiple options should be prepared so that they can be used effectively according to the jurisdictional circumstances. However, the circumstances and market practices differ, and the appropriate types of tools and applicable conditions, etc. are likely to vary, from one jurisdiction to another. Therefore, we do not believe that internationally uniform guidance is required.

- In Japan, any investment trust contract stipulates that if, for some reason, trading of assets accounting for a certain proportion of the entire asset holdings in the OEF is suspended or ceased in the market where such assets are mainly traded, the acceptance of subscriptions and redemptions of the OEF be suspended until such situation is resolved. In addition, in the event that such a situation should arise, measures are implemented to suspend the receipt of applications for subscriptions and redemptions.

Sincerely yours,

K. Matsushita

Koichi Matsushita
Chairman
The Investment Trusts Association, Japan