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Secretariat of the Financial Stability Board
Bank for International Settlements
CH-4002 Basel
Switzerland

Submitted via e-mail: fsb@fsb.org

Re: Addressing Structural Vulnerabilities from Liquidity Mismatch in Open-Ended Funds – Revisions to the FSB's 2017 Policy Recommendations

Dear Sir/ Madam:

State Street Corporation ("State Street") appreciates the opportunity to comment on the FSB's revised 2017 Recommendations ("the Recommendations") to address structural vulnerabilities from Asset Management Activities in relation to liquidity mismatch in open-ended funds, as described in the consultation report ("the Report") issued on July 5, 2023.

Headquartered in Boston, Massachusetts, State Street is a global custody bank which specializes in the provision of financial services for institutional investor clients, such as asset owners, asset managers and official sector institutions. This includes investment servicing, investment management, data and analytics, and investment research and trading. With $39.6 trillion in assets under custody and administration and $3.8 trillion in assets under management[1], State Street offers its clients the ability to transact and hold assets in more than 100 geographic markets globally.[2] State Street Global Advisors ("SSGA") is the investment management division of State Street Corporation, managing assets for public and private retirement plans, large corporations, non-profit organizations,

[1] As of June 30, 2023.
[2] As of June 30, 2023.

insurance companies, banks, sovereign wealth funds, central banks, and other official institutions. State Street Global Advisors is the world's fourth-largest asset manager and sponsors the SPDR® family of exchange traded funds ("ETFs").

State Street supports the FSB's approach of focusing on liquidity mismatch and "first-mover advantage" risks for certain investors while steering away from implying a 'one-size fits-all' approach across all open-ended funds and jurisdictions. In this sense, while appreciating the FSB's intention of providing a principle-based approach, we acknowledge that open-ended funds vary significantly in their portfolio investments and liabilities, investment strategies, investor flows, and shareholder bases and this should be recognized by the applicable liquidity requirements.

We support several aspects of the Report such as:

i. the exclusion of money market funds ("MMFs") and exchange-traded funds ("ETFs") from the scope of the Recommendations;
ii. the FSB's decision not to include minimum regulatory requirements for liquid asset holdings across the fund sector[3];
iii. the need for funds to ensure that their redemption terms are consistent with their investment strategies and liquidity of portfolio assets.

However, we question the FSB's analysis which would suggest that *"there had been no measurable reduction in the degree of structural liquidity mismatch across the OEF sector. Moreover, as the OEF sector has grown in absolute terms, […] the potential impact of vulnerabilities that can arise from OEFs' structural liquidity mismatch has also grown."*[4]

Since the publication of the FSB's first set of Recommendations in 2017, the regulatory framework for the asset management industry has gone a long way to address risks of liquidity mismatches both in the U.S. and in Europe. In the U.S., with the adoption of Rule 22e-4 (the "Liquidity Rule") under the Investment Company Act of 1940 (the "1940 Act"), liquidity risk management programs and related disclosures have resulted in meaningful benefits to industry and investors. In Europe, there is a well-developed regime for managing fund liquidity risk in the form of the Undertakings for the Collective Investment in Transferable Securities ("UCITS funds") and Alternative Investment Fund Managers Directive frameworks.

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[3] FSB, Consultation on Addressing Structural Vulnerabilities from Liquidity Mismatch in Open-Ended Funds, July 2023, footnote 18.
[4] FSB, Consultation on Addressing Structural Vulnerabilities from Liquidity Mismatch in Open-Ended Funds, July 2023, p. 7.

The resiliency of both regimes became apparent during the March 2020 financial turmoil, when cases of 1940 Act registered funds or UCITS funds failing to make timely payment on shareholder redemptions were extremely rare, with limited liquidity issues and satisfying investor redemption demand with rare exceptions.

Moreover, strong liquidity management has always been part of fund managers' fiduciary duty, and asset managers have a wide range of recognized tools/best practices in place to manage fund liquidity and redemptions. This includes tools for managing day-to-day liquidity, as well as tools to cope with more extreme tail risk events and first-mover advantage risks. These tools range from ongoing monitoring of asset liquidity compared to expected redemptions, to more proactive measures in times of financial stress, such as swing pricing, redemption fees and gates. Not all such tools are necessary or appropriate in all markets, or for all fund types, nor is dilution always a material risk, and fund managers are able to assess this with the help of liquidity management playbooks which by now should be codified in most jurisdictions.

While there is benefit in the alignment of regulations from one jurisdiction to another – through for example consistent global taxonomies for measuring exposures, liquidity and leverage risks – individual market specificities should continue to be respected, and the FSB's Recommendations should remain flexible enough so that they can easily be incorporated into each jurisdiction.

In this spirit, we oppose other elements of the Report which appear too prescriptive:

i. the bucketing approach;
ii. the imposition of prescriptive implicit costs in the calculation of Liquidity Management Tools ("LMTs") and anti-dilution tools.

Further comments on the FSB's Report follow below together with our answers to selected questions.

The additive liquidity of ETFs

As noted above, we strongly welcome the FSB's approach in excluding ETFs from the scope of the revised Recommendations. We agree with the FSB's conclusion that ETFs have different liquidity characteristics than other types of open-ended funds. Liquidity is a key product development and design feature of an ETF and local regulatory liquidity rules make sure that ETFs would not be able to list if they were not liquid[5].

Moreover, the unique ETF structure always provides two sources of liquidity for investors, a 'primary' source which can be accessed via an authorized participant and a 'secondary' one which can be accessed directly on the

[5] In the U.S. all ETFs must abide by Section 22-e4 of the 1940 Act.

exchange where the ETFs are listed and traded. Even at times of market stress, there is sufficient secondary market ETF liquidity for investors to trade without accessing the primary market and subsequently the broader market. Therefore, the concerns related to on-demand liquidity, first-mover advantage, and imposition of transaction costs on non-redeeming shareholders do not apply to ETFs to the same extent as for other open-ended funds.

The specific features and potential vulnerabilities associated with ETFs have been examined in other fora and most recently by the IOSCO Final Report on "Good Practices Relating to the Implementation of the IOSCO Principles for Exchange Traded Funds"[6]. IOSCO recognized that the ETF structure has remained resilient during historical stress events, that no major gaps or regulatory issues have been identified, and concluded that ETFs have no structural issues that bear on financial stability.

A misguided bucketing approach

We recognize that, in specific circumstances, it can be hard to justify certain investment strategies/asset classes in daily dealing funds. As noted above, we have no objection to more targeted means of addressing extreme forms of liquidity mismatch in those funds, but this process should start at inception through product design or through the appropriate deployment of LMTs, it should not be done by means of a 'one-size fits-all' approach that will inevitably lead to confusion around the thresholds and the methodologies that should drive the underlying classifications. Given the fluid nature of liquidity, thresholds always run the risk of introducing cliff effects at times of stress.

Moreover, a bucketing approach would not be consistent with the liquidity risk management approach developed in Europe. EU funds closely monitor their liquidity set-up and rely on fund stress testing to determine whether their liquidity profile would resist a redemption shock[7]. Thresholds and buckets cannot substitute for this detailed liquidity assessment. The proposed liquidity bucketing would therefore only result in additional compliance costs for European investment funds. Similarly, the proposed bucketing approach is fundamentally different from the one adopted in the U.S. with the Liquidity Rule under the 1940 Act, which maintains daily redeemability as a key feature for open-ended mutual funds.

For these reasons, we would recommend eliminating the three-bucket framework. Local liquidity regulations, affecting 1940 Act funds in the U.S. and UCITS and AIFs funds in Europe, are better positioned to set liquidity

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[6] IOSCO, "Good Practices Relating to the Implementation of the IOSCO Principles for Exchange Traded Funds", May 2023.
[7] In the EU, this is consistent with the MiFID II product governance requirements as well as the ESMA's Guidelines on liquidity stress testing in UCITS & AIFs, from July 2020. In the UK, COLL 6.12.9R requires the authorized fund manager to conduct, where appropriate, periodic stress tests and scenario analysis to address risks arising from potential changes to market conditions for each UCITS.

parameters to individual open-ended funds. Additional guidance should remain targeted to those open-ended funds that invest primarily in illiquid assets.

Responses to selected questions

1. Should "normal" and "stressed" market conditions be further described to facilitate the application of the bucketing approach? If yes, how would you propose describing such conditions?

As discussed above, we consider the bucketing approach to be misguided in that it forces a top-down categorization on all open-ended funds and it seems to assume "stressed" market conditions as a baseline for daily determination of market liquidity. Creating and enforcing a linkage between asset liquidity and fund liquidity may lead to unintended outcomes, which we will highlight further below.

There is no widely or industry-accepted approach to quantifying asset liquidity, whether in normal or stressed market conditions. The multi-faceted aspect of liquidity, including expected or assumed trading size, may lead to different outcomes across funds of similar size, assets and strategy. Liquidity always remains an ongoing and dynamic exercise and rigid definitions may compromise a fund's ability to achieve its objectives and meet the expectations of its investors.

The dynamic nature of liquidity suggests that it is preferable to focus regulation on fund managers' preparedness to changing market conditions rather than trying to define what exactly constitutes "stressed" conditions.

Another concept that is hard to define and quantify is that of "excess redemptions". As discussed in the Report, excess redemptions resulting from a structural liquidity mismatch are driven, amongst others, by: (i) externalities, through first-mover advantage; and/or (ii) unexpected or misunderstood liquidity mismatch and associated costs. The Report correctly highlights the limitation of its own findings, which we believe should not result in an expectation or intention for asset managers or NCAs to consider form of excess redemption measure in their liquidity management programs.

2. Are the examples of the factors that should be considered in determining whether assets are liquid, less liquid or illiquid appropriate? Are there other factors which should be considered and, if yes, which ones and why?

We urge caution not to over-engineer the assessment and classification of liquidity, which may lead to an overly prescriptive estimate of liquidity which is not realistic due to market dynamics and changes in factors that drive liquidity. Judgments about asset liquidity are always based on observations and estimates, and the liquidity profile of a fund is always dynamic, with liquidity needs that need to be assessed on an ongoing basis.

The Report helpfully provides for a non-exhaustive list of factors that can concur to the determination of the liquidity of a particular asset class, even though some of the factors are difficult to estimate and quantify – i.e. valuation certainty, the efficiency and effectiveness of the pricing mechanism, operational features and potential frictions – so they shouldn't always be considered all together.

3. Is the use of specific thresholds an appropriate way to implement the bucketing approach? If yes, are the proposed thresholds for defining funds that invest mainly (i.e. more than 50%) in liquid or less liquid assets and funds that allocate a significant proportion (i.e. 30% or more) of their assets to illiquid assets appropriate? If not, which thresholds would be more appropriate and why?

As noted above, we disagree with the bucketing approach as proposed by the FSB.

Creating rigidity in the framework of liquidity management, through thresholds or otherwise, could lead to boundary problems and other unintended risks and costs, especially if the regulatory approach is dependent on measurements of liquidity that are not widely accepted or adopted. Bucketing and thresholds are not a good substitute for the profiling work around liquidity that fund managers already have in place.

We reiterate our support for a differentiated regional regulatory approach as opposed to a one-size fits-all approach globally.

4. Should the FSB consider recommending the use of a decreased redemption frequency (on a standalone basis), a longer notice period (on a standalone basis) or a longer settlement period (on a standalone basis) for OEFs investing in less liquid assets that do not meet the expectation on the implementation of anti-dilution LMTs? Or should these measures be used in combination, considering the risk of redemptions crowding around certain dates?

As noted above, we have no objection to more targeted means of addressing extreme forms of liquidity mismatch in illiquid funds, but this process should start at inception through product design or through the appropriate deployment of LMTs, not through a prescriptive bucketing approach.

In the U.S., 1940 Act funds do not have the option to offer decreased redemption frequency and are only allowed for settlements of redemptions to extend to 7 days under less liquid market conditions. In Europe, UCITS funds have the ability already to defer redemptions that are higher than 10% of the NAV on any given day over a 7 day period, while national competent authorities are empowered through the approval process to ask UCITS funds to justify the dealing frequency in light of the liquidity of the underlying assets.

We would encourage the FSB in its regulatory approach to acknowledge the existing local regulatory frameworks and to encourage a fund and asset-specific approach to notice periods and the use of LMTs.

5. Would additional guidance on factors to consider when setting the redemption frequency or notice or settlement period be helpful? If yes, in what respect?

See previous response.

6. Do the proposed changes to Recommendations 4 and 5, when read together with the proposed IOSCO guidance on anti-dilution LMTs, help achieve greater use and a more consistent approach to the use of anti-dilution LMTs? If not, what changes should be proposed to the FSB Recommendations?

With regards to Recommendations 4 and 5, we are supportive of the guidance that seeks to ensure a broad set of tools for liquidity management, and we appreciate the statement that authorities should reduce operational and other barriers that prevent their use in certain jurisdictions.

We support expanding the availability and use of LMTs and anti-dilution tools in accordance with jurisdictional specificities. Investment managers, in pursuing their fiduciary duty, remain best placed to activate and calibrate these tools on the basis of their fund's investment strategy and portfolio liquidity. The focus should remain on material dilution risks and the inclusion of implicit transaction costs should remain on a best effort basis, provided that the trade sizes of the fund are large enough to result in a market impact. Because implicit transaction costs are difficult to estimate (especially due to inconsistency of market impact data) we struggle to see how the inclusion of these implicit costs will be able to drive consistency among open-ended funds, and therefore the best interest of investors.

7. Are there any obstacles (either universal or jurisdiction specific) to the implementation of the revised FSB Recommendations on the use of anti-dilution LMTs? If yes, what additional recommendations or guidance would help address such obstacles?

SSGA has a good experience with LMTs, and available tools include swing pricing, redemption fees, in-kind redemptions, redemption limits, settlement delay, gating, NAV suspension and fund liquidation. Swing pricing in particular has been widely deployed across SSGA and EU and UK-registered funds in recent years, both for subscribing as well as redeeming investors. The swing pricing framework in Europe remains optional and leaves funds with the ability to set their own swing factors and thresholds (with no mandatory inclusion of market impact in swing factors).

Europe's experience is not instructive for the U.S. marketplace given that the shareholder base, fund operating models and fund distribution infrastructure differ significantly from those in the U.S. where relationships between mutual funds and their extensive intermediary networks, and shareholders' ability to purchase and sell fund shares on a timely basis, make the operationalization of swing pricing particularly cumbersome.

Where operational issues exist, we urge the relevant authorities to convene the wider market ecosystem to address the infrastructure issues.

8. Would additional recommendations or guidance be helpful in clarifying the expectation that OEF managers have internal systems, procedures and controls enabling them to use anti-dilution LMTs as part of the OEFs' day-to-day liquidity risk management?

We agree that effective governance arrangements are crucial for the deployment of liquidity and anti-dilution tools, and that this process should be integrated into wider fund governance. Current market practice should already integrate this into Liquidity Playbooks, outlining information about available risk mitigants and decision-making processes relevant to each fund range. The appropriate structure will vary depending on fund type and jurisdiction and we would discourage any recommendations or prescriptive guidance which would prescribe specific models or factors to be taken into account in the calculation of anti-dilution tools, which would result in a limitation of the judgement of Funds Managers to act in the best interest of investors.

9. Do you agree with applying anti-dilution LMTs to subscribing investors as well as to redeeming investors? If not, why?

We agree.

10. Would additional international guidance on the availability and use of quantity-based LMTs be useful? If yes, what aspects should such guidance focus on? If not, why?

Please refer to our response to Question 6. We welcome the FSB's recommendation for enhanced guidance/engagement with fund managers in exceptional cases of particularly stressed market dislocation, in order to facilitate the application of liquidity management tools, as opposed to mandate direct intervention by policy makers[8].

[8] FSB, Consultation on Addressing Structural Vulnerabilities from Liquidity Mismatch in Open-Ended Funds, July 2023, p. 20.

11. Do the proposed changes to Recommendation 2, when read together with the proposed IOSCO guidance on disclosure to investors, help enhance disclosure to investors on the use of anti-dilution LMTs? If not, what changes should be proposed to the FSB Recommendations?

We agree that investors should receive appropriate disclosure concerning what anti-dilution tools are and the fact that the fund can utilize them. In the prospectus, funds are able to clearly disclose the presence and possible use of LMTs. This should allow investors to take the associated cost of liquidity into account in their investment decisions, without the need to disclose details about calculation methodologies of triggers or factors. UCITS and U.S. 40 Act funds are both already subject to extensive disclosure requirements, which reflect the availability of LMTs and the circumstances of when they might be invoked. Current regulatory requirements in those jurisdictions are therefore already adequate and empower fund managers to adopt and adjust anti-dilution LMTs as needed.

12. Should any other 2017 FSB Recommendations (Recommendations 1, 6, 7 or 9) be amended to enhance the clarity and specificity of the intended policy outcomes? If yes, which ones and why?

No response.

13. Are there any other aspects that should be considered in the revised FSB Recommendations to ensure that they are effective from a financial stability perspective?

No response.

Conclusion

Once again we appreciate the opportunity to comment on the FSB's Recommendations and welcome the opportunity to further engage with the FSB on the topics raised in the Report. Please feel free to contact me should you wish to discuss the contents of this submission in greater detail.

Sincerely,

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