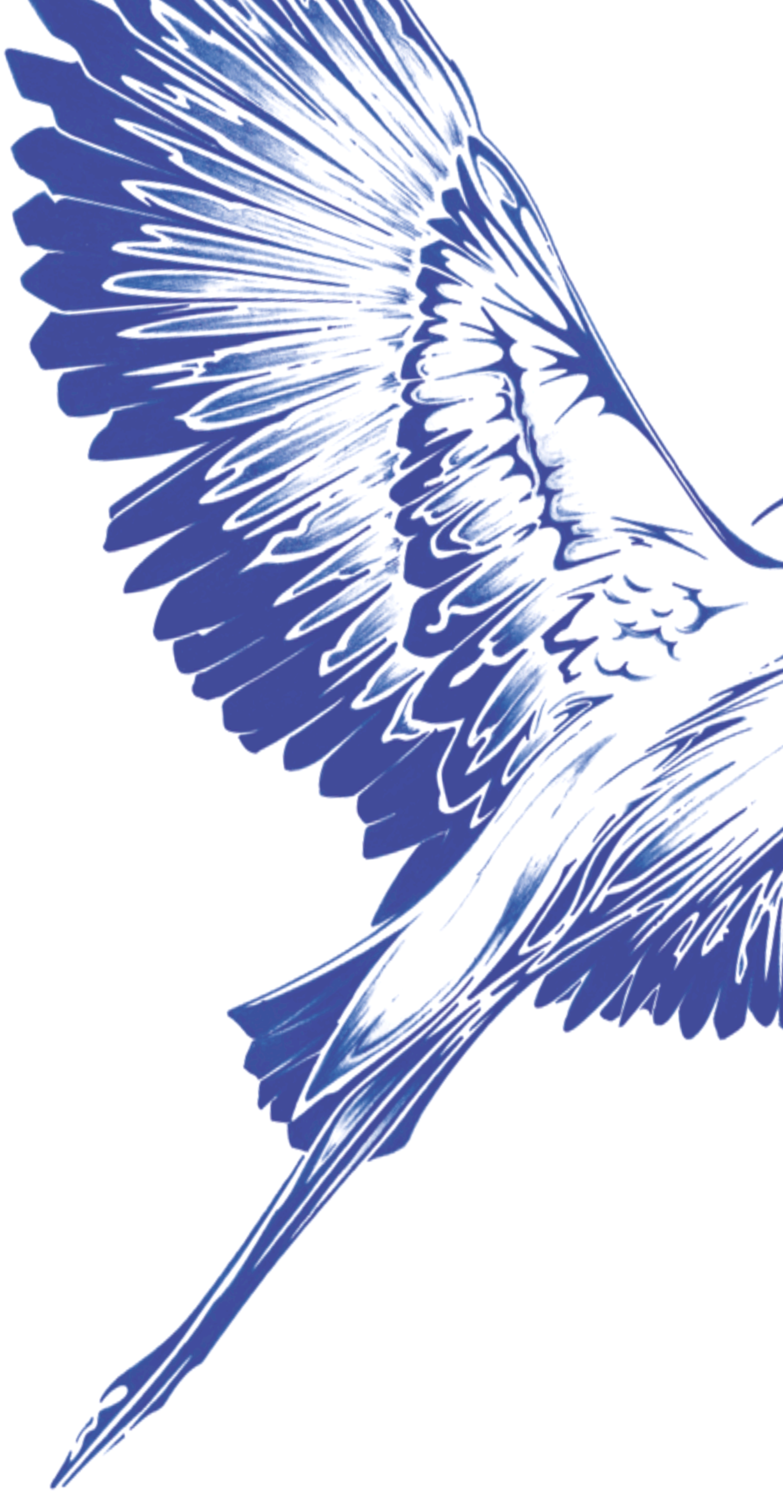
CLEVELAND & CO

External in-house counsel

IOSCO RECOMMENDATIONS FOR INVESTMENT FUNDS

7 March 2018



The International Organization of Securities Commissions ("**IOSCO**") has published two final reports:

1. Recommendations for liquidity risk management ("**LRM**") for Collective Investment Schemes ("**CIS**"); and
2. Open-ended Fund Liquidity and Risk Management – Good Practices and Issues for Consideration.

These contain recommendations that:

- seek to improve LRM practices of open-ended CIS as part of its mission to protect investors, ensure fair and efficient financial markets and reduce systemic risk; and
- provide practical information, examples and good practices regarding open-ended fund LRM to supplement its recommendations.

Below is a summary of the key findings of each report.

Recommendations	Key findings	Impact on firms

1. RECOMMENDATIONS FOR LRM FOR CIS

a) The CIS Design Process	The responsible entity ("**RE**") should draw up an effective LRM process, compliant with local jurisdictional liquidity requirements. The LRM process needs to be able to be effective in varied market conditions. Where the CIS is likely to be at a greater risk of liquidity problems, the responsible entity should construct (and perform) a more rigorous LRM process. For example, this includes CIS with: – a high proportion of illiquid assets; and/or – a narrow investor base. IOSCO wants to ensure that liquidity is managed to safeguard and protect the interests of investors, including in stressed market conditions to defend against any structural vulnerabilities that could potentially develop into extended market dislocations and financial instability.	The RE should consider the liquidity of the types of instrument in which the CIS's assets will be invested, at an appropriate level of granularity, and should seek to ensure that, taking into account all of the CIS's portfolio as a whole, these are consistent with the CIS's ability to comply with its redemption obligations or other liabilities. A RE does not need to construct a new process for each new CIS if it already operates a CIS with similar characteristics. However, it must ensure the process remains appropriate and relevant and sufficiently bespoke for any

Recommendations	Key findings	Impact on firms
		other CIS it is used for.
b) The RE should set appropriate liquidity thresholds which are proportionate to the redemption obligations and liabilities of the CIS	The RE should set appropriate internal definitions and thresholds for the CIS's liquidity, which are in line with the principle of fair treatment of investors and the CIS's investment strategy. The thresholds should act as a signal to the RE to carry out more extensive in-depth, quantitative and/or qualitative liquidity analysis as part of the risk management process (with the intention that the RE would then take appropriate remedial steps if the analysis revealed vulnerabilities).	Firms should place stricter internal thresholds on liquidity than their current local regulatory requirements. For example, a daily dealing CIS would be expected to have stricter liquidity requirements than a CIS sold on the basis that investors would not be expected to redeem before a set period expired; or a CIS that invested predominantly in real estate but promised frequent redemption rights to its investors might consider it appropriate to hold a relatively large stock of more liquid assets (which could be related to real estate) as well, because of the expected length of time it would take to dispose of physical properties in order to meet redemption requests.

Recommendations	Key findings	Impact on firms
c) The RE should carefully determine a suitable dealing frequency for units in the CIS	Where there aren't any specified local requirements, the RE should ensure that they set a dealing frequency for units in the CIS which is realistic and appropriate for its investment objectives and approach, taking account of its LRM process, and allowing redemptions to be processed effectively.	REs should give due consideration to the structure of the fund and the appropriateness of the dealing frequency having regard to the: – target investor base; – investment strategy; – objectives; and – expected liquidity of the assets. The ability to gain certain tax treatment for a CIS, or to access a wider market for distribution, should not lead REs to set a more frequent dealing frequency for units in the CIS than is appropriate.
d) The consideration of underlying liquidity throughout the entire life cycle of the fund (design, pre-launch, launch and ongoing daily operation)	REs should ensure that the CIS' dealing (subscription and redemption) arrangements are appropriate for its investment strategy and underlying assets throughout the entire product life cycle, starting at the product design phase. The initial design of a CIS presents an opportunity to put arrangements in place to underpin effective LRM. CIS should be designed to meet their redemption obligations. If those obligations cannot be met in a particular situation, then it must be managed in a prudent and orderly fashion, which is in the best interests of investors.	As part of the initial design process for open-ended CIS, a documented assessment should be conducted of the liquidity risks likely to face the CIS, having regard to: – its proposed investment strategy; – its target investors (as available to the RE); and – the assets and instruments it is intended to invest in. The assessment should set out why the relevant design features of the proposed CIS constitute an appropriate structure within which to manage liquidity risk in both normal and reasonably foreseeable stressed market conditions. This should include consideration as to the quality of

Recommendations	Key findings	Impact on firms
		information about the investor base which is made available by different distribution channels for the CIS. Given the importance of the design decision, the assessment should be subject to an internal approval process at an appropriate senior management and/or board level within the responsible entity where it can be reviewed and updated on an on-going basis from both portfolio management and risk management perspectives. These reviews should consider the following aims: – protect investors; – maintain market integrity; and – promote financial stability. In carrying out the design process, there should be due regard to: – liabilities; – current and historical liquidity of the assets and instruments to be invested in; and – additional liquidity management tools to help manage redemptions in stressed market conditions particularly those that could lead to severe market dislocation.

Recommendations	Key findings	Impact on firms
e) The RE should consider liquidity aspects related to its proposed distribution channels	The RE should consider how the planned marketing and distribution of the CIS are likely to affect its liquidity. This should also include consideration of market conditions when forecasting their expectations for the volume, type and distribution of investors, as well as the effectiveness of individual distribution channels.	A RE should take all reasonable steps to obtain investor concentration information from nominees to assist its liquidity management, for example, via contractual arrangements.
f) The RE should ensure that it will have access to, or can effectively estimate, relevant information for liquidity management	The RE should consider its information needs in order to effectively manage liquidity risk in the CIS, and whether it will be able to access that information during the life of the CIS.	Where the CIS plans to invest in other CISs, the responsible entity should be satisfied that it can obtain information about the underlying CISs' approaches to liquidity.
g) Disclosure to investors	The RE should ensure that liquidity risk and its LRM process are effectively disclosed to investors and prospective investors. This should include an explanation of: – why and in what circumstances it might crystallise; – its significance and potential impact on the CIS and its unit-holders; – a summary of the process by which the RE aims to mitigate the risk. Disclosures concerning liquidity have the potential to provide investors with information to determine whether the liquidity risk appetite matches the liquidity risk profile of the CIS. In particular, such disclosure is most likely to be beneficial where the CIS is invested in assets or instruments which have a record of significantly varying liquidity across the financial cycle or where there is insufficient historical evidence to assess whether liquidity will vary significantly across the financial cycle.	Disclosure of what actions the RE would take in the event of a liquidity problem would be useful information. The explanation should set out clearly how the investor could be affected. Explanation of any tools or additional measures that could affect redemption rights should be included in the CIS's offering documents. The explanation should include what the tool or measure is, what effect its use will have on CIS liquidity/investor redemption rights and examples of when the tool or measure might be applied. A RE must take care to ensure that these descriptions are clear and comprehensible to investors. The RE must not consider disclosure of liquidity risk, and information about its

Recommendations	Key findings	Impact on firms
		LRM process, to be a substitute for the actual operation of an effective policy. Basic day-to-day liquidity information should be disclosed to investors, for example, the dealing frequency of the CIS and how to buy/sell units. Additional disclosure requirements to investors should include one or more of the following: – a commitment in the initial offering documentation to provide to investors on a periodic basis and where appropriate, information regarding the investment portfolios of the CIS that may allow investors to assess the liquidity risk attached to the CIS e.g. holdings of various asset classes/types of securities, detailed holdings of individual securities; and – disclosure in the CIS offering documents of the general approach the CIS will take in dealing with situations where it is under liquidity pressure from a heightened level of net redemption requests. Disclosure should be proportionate to risks and sufficient detail should be disclosed to make investors aware of material liquidity risks.

Recommendations	Key findings	Impact on firms
h) Day-to-day liquidity management	The RE's LRM process must be supported by strong and effective governance. Governance is of paramount importance for an effective LRM process, as even the most sophisticated liquidity modeling and perfectly predicted cash flows can be made redundant by the lack of effective oversight or controls to deal with the information produced.	Appropriate escalation procedures should be in place if problems are envisaged or identified. There should be an appropriate degree of independent oversight involved in reviews of the LRM process.
i) The RE should effectively perform and maintain its LRM process	After a liquidity risk-management process is established pre-launch, it must be effectively performed and maintained during the life of the CIS. The RE should take account of the: – investment strategy; – liquidity profile; and – redemption policy of the CIS.	The RE should undertake regular periodic reviews of the effectiveness of the LRM process and the process should be updated as appropriate. For example, if the CIS is to invest in a new type of asset or if the investor profile has changed materially (from that anticipated) – for example, if a CIS originally expected to have a large number of retail investors but in fact only attracts a small number of institutional investors each owning a significant share of the CIS – the policy should be reviewed and updated, if deemed appropriate.

Recommendations	Key findings	Impact on firms
j) The RE should regularly assess the liquidity of the assets held in the portfolio	The liquidity risk-management process should enable the RE to regularly: – measure; – monitor; and – manage the CIS's liquidity. The RE should take into account the interconnection of liquidity risk with other factors such as market risk or reputational risk.	The RE should ensure compliance with defined liquidity limits and the CIS's redemption policy, whether these are set by national regulation, set out in the LRM process, detailed in the CIS's documentation or other internal thresholds. The liquidity assessment of the CIS's assets should consider obligations to creditors, counterparties and other third parties.
k) The RE should integrate liquidity management in investment decisions	The RE should consider: – the liquidity of the types of instruments it intends to purchase or to which the CIS could be exposed; – the liquidity effects of the investment techniques/strategies it uses, before transacting; and – the impact that the transaction or technique/strategies will have on the overall liquidity of the CIS.	REs should only carry out transactions if the investment or technique/strategy employed does not compromise the ability of the CIS to comply with its redemption obligations or other liabilities. The assessment of liquidity risk includes: – the consideration of the type of asset; – an analysis for each type of asset and the number of days it would take for RE to sell the asset without materially moving the market prices.

Recommendations	Key findings	Impact on firms
l) The LRM process should facilitate the ability of the RE to identify an emerging liquidity shortage before it occurs	The LRM process should aim to assist the RE in identifying liquidity pressures before they crystallise, thus enabling it to take appropriate action and respecting the principle of fair treatment of investors. During stressed market conditions, the RE should seek to ensure that the interests of investors are safeguarded and CIS investors are being treated fairly. As such, the RE should seek to maintain the investment strategy and attempt to maintain alignment between the funds' investment strategy and its liquidity profile taking into account investors' best interests, including ensuring that remaining investors are not left with a disproportionate share of potentially illiquid assets. This could involve the monitoring and management of large redemptions by investors, which have the potential to reduce the normal liquidity profile to the extent reasonably practicable.	REs should make best efforts to manage future cash flows so as to assist with liquidity management, for example, it may be possible to negotiate a pre-notice period with brokers before changes in margin call formulas become effective, or to negotiate longer periods for repo agreements.
m) The RE should be able to incorporate relevant data and factors into its LRM process in order to create a robust and holistic view of the possible risks	In performing the LRM process, the RE should consider quantitative and qualitative factors to seek to ensure that in all but exceptional circumstances, the CIS can meet its liabilities as they fall due. One of the key challenges in liquidity management is taking appropriate account of the uncertainty in future investor behaviour both in normal market conditions and, in particular, in stressed markets.	Key information should be taken into account which, where known or available or subject to sensible estimate, could improve the capability to manage liquidity risk. The more a RE knows about its investor base, the better able it will be to plan for and manage future liquidity needs. REs should make reasonable efforts to understand their investor base. This involves at least considering the marketing and distributing channels of the CIS, and analysing the historical redemption patterns of different types of investors.

Recommendations	Key findings	Impact on firms
n) Fund level stress testing	The RE should conduct ongoing liquidity assessments in different scenarios, which could include fund level stress testing, in line with regulatory guidance. Stress testing can assess how the liquidity profile of, or redemption levels of, a CIS can change when faced with various stressed events and market scenarios. It is an important component of a RE's LRM process.	Stress testing should support and strengthen the ability of the REs in managing liquidity risk appropriately in the best interests of investors. Stress testing can be used by REs to assess the liquidity characteristics of the CIS's assets relative to the CIS's anticipated redemption flows under stressed market conditions and to tailor the CIS's asset composition, liquidity risk management and contingency planning accordingly.
o) Appropriate records and relevant disclosures relating to the performance of its LRM process	As part of performing their LRM process, REs should be able to demonstrate that robust liquidity arrangements are in place and work effectively. In order to support the successful implementation of and adherence to the process it should be effectively documented and communicated across the RE's business. Such documentation should be reviewed as needed, and at least annually in any event.	Where an additional measure is applied (e.g. the imposition of a side pocket), existing and potential investors must be informed in an appropriate manner, and kept informed over time (for example, by material on the RE's website). In some jurisdictions, regulators and existing investors must also be kept informed and must approve the application of such measures.

Recommendations	Key findings	Impact on firms
p) Securities regulators	Additional guidance is provided for securities regulators to promote good liquidity management practices for CIS. IOSCO encourages securities regulators to oversee the development and execution of the LRM programs to help minimize the possibility of adverse effects on markets.	Where securities regulators have concerns that appropriate consideration may not have been given, where allowed by local law and regulation, they should exercise their regulatory powers to seek to ensure all reasonable steps are taken by REs to remedy the situation.
q) Contingency planning	The RE should put in place and periodically test contingency plans with an aim to ensure that any applicable liquidity management tool can be used where necessary; and The RE should consider the implementation of additional liquidity management tools to the extent allowed by local law and regulation to protect investors from unfair treatment or prevent the CIS from diverging significantly from its investment strategy.	REs should plan for such events having regard to whether: – the operational capacity exists to implement and unwind any such tools in a transparent, fair and orderly manner in the best interest of investors; – in those jurisdictions where relevant, the operational capacity continues to exist to exercise such tools at short notice if required by a relevant authority to do so; – the legal basis for the exercise of every tool disclosed in the CIS documentation continues to be assured by the RE to the satisfaction of the relevant decision makers of the RE; – the escalation process for the implementation of any such tools can be conducted in a prompt and orderly manner; – there continues to be procedural clarity as to who is responsible for

Recommendations	Key findings	Impact on firms
		initiating consideration of and deciding on the exercise any such tools; – there are policies in place as to when the tools will be actively considered and that these policies are documented and take into account applicable law and regulation and be sufficiently detailed to make the governance of and responsibility for the relevant decisions clear; – the capacity exists to keep investors and relevant authorities informed promptly of developments and all necessary information should be provided at short notice to seek consent from relevant authorities for the use of such tools. Additional LRM tools, provided that such tools are permitted in the relevant jurisdiction and contained within the CIS constitutional document, can provide valuable assistance in the management of stressed market conditions.

Recommendations	Key findings	Impact on firms

2. OPEN-ENDED FUND LIQUIDITY AND RISK MANAGEMENT – GOOD PRACTICES AND ISSUES FOR CONSIDERATION

Recommendations	Key findings	Impact on firms
a) Ensuring consistency between a fund's redemption terms and its investment strategy	Asset managers are required to establish LRM policies and procedures that form an integral part of their broader risk management framework.	REs are expected to: – have robust procedures at the design phase to determine the appropriate product features to promote/support the fund being able to meet redemption demands as they come due; – continuously monitor their funds' liquidity profiles and ensure that appropriate levels of liquidity are maintained in the funds; – ensure they have the ability and capacity to make any appropriate adjustments including the activation of tools to restrict redemptions in exceptional cases; and – take into account the best interest of investors.

Recommendations	Key findings	Impact on firms
b) Availability and effectiveness of LRM tools	IOSCO presents scenarios in which an asset manager may use liquidity management tools to address liquidity issues in certain funds. **Tools that aim at passing on transactions costs to redeeming investors:** – swing pricing, – valuation according to bid or ask prices; and – anti-dilution levies. **Tools that restrict access to investor capital:** – redemption gates; – side pockets; – notice periods; and – suspension of redemptions.	Tools and additional measures should only be used where fair treatment of investors is not compromised, and where permitted by the law and regulation applicable to the CIS.

WHY WE'RE DIFFERENT

Cleveland & Co are specialists in financial services, investment management and commercial contracts and related courses. Our team's in-house experience means we understand client challenges and we work alongside you to create solutions. We can provide insight on real vs hypothetical risks and help your team evolve.

WE OFFER

Cleveland & Co offer you fixed fees and retainer structures that provide you with certainty of cost and we offer industry experience that cuts through common legal complexity.

CONTACT

EMMA CLEVELAND

Managing Director

+44.79.6387.8756
ecleveland@cleveland-co.com
www.cleveland-co.com