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AFGôs response to the IOSCOôs consultation report on ñPrinciples of Liquidity Risk Management for Collective Investment Schemesò

The Association Française de la Gestion financière (AFG)[1] welcomes the IOSCOôs consultation report on the ñPrinciples of Liquidity Risk Management for Collective Investment Schemesò.

Introductory remark

Our members very much welcome this consultation on a topic growing in importance inside asset management firms. Liquidity is an important market concept that tends to be more and more in need of ñmanagement/monitoringò in relation to recent market trends, especially for shorter term management styles/funds.

Even if as a general rule the liquidity is to be tightly monitored in a fund, we are however strongly against a certain ñdictatorshipò of liquidity. Indeed, the tendency to privilege liquidity over longer term assets and vehicles contributes to a higher volatility and impedes more stable financing of the economy. There should be a balance between the need for shorter term placements versus longer term ones without any hierarchical line. We strongly believe

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[1] The Association Française de la Gestion financière (AFG)[1] represents the France-based investment management industry, both for collective and discretionary individual portfolio managements.

Our members include 411 management companies. They are entrepreneurial or belong to French or foreign banking or insurance groups.

AFG members are managing 2600 billion euros in the field of investment management, making in particular the French industry the leader in Europe in terms of financial management location for collective investments (with nearly 1600 billion euros managed from France, i.e. 23% of all EU investment funds assets under management), wherever the funds are domiciled in the EU, and second at worldwide level after the US. In the field of collective investment, our industry includes ï beside UCITS ï the employee savings schemes and products such as regulated hedge funds/funds of hedge funds as well as a significant part of private equity funds and real estate funds. AFG is of course an active member of the European Fund and Asset Management Association (EFAMA) and of the European Federation for Retirement Provision (EFRP). AFG is also an active member of the International Investment Funds Association (IIFA).

that liquidity should be analysed rather in the context of asset liability matching than as a general one-size-fits-all objective.

Monitoring liquidity requires a certain degree of organisation of the function (and/or the delegation of certain aspects) at the asset management firm. Liquidity is not a stable concept and there should be flexibility in the manner firms handle with the matter so as to be efficient relative to the market stance. Measures may be taken at the fund level or not. Indeed, the fund itself may not always be the most appropriate level as in some cases it would be more efficient to define a transversal process that takes into different characteristics and/or criteria.

AFG would like to remind that European investment funds managers are subject to high standards of liquidity risk management. UCITS managers, especially, are required to employ an appropriate liquidity risk management process in order to ensure that the funds they manage are able to meet redemption requests from investors. This liquidity risk management process is part of the permanent risk management function that UCITS management companies must establish which must be functionally and hierarchically independent from other departments within the management company. Managers are required to measure and manage at any the risks to which the fund is or might be exposed, including the risk of massive and unexpected redemptions. It should therefore be emphasized that risk management in UCITS is already state-of-the art and has been further enhanced by the entry into force of the UCITS IV Directive in July 2011 which has introduced even more detailed provisions on internal control mechanisms for the UCITS management company.

In the AIFMD the Risk Management function, including the management of liquidity risks will be functionally and hierarchically separated from the operating units of the AIFM.

The robust liquidity risk management processes put in place by European investment fund managers certainly explains for a large part that the vast majority of European investment funds went through the global financial crisis in 2008 without major problems.

It is worth mentioning that in exceptional circumstances where ï despite the liquidity management process in place - a fund would temporarily be unable to meet the redemption requests from investors, the fund manager still has the possibility to temporarily suspend redemptions in the interest of its unit holders (as foreseen in Article 84 of the UCITS directive).

Detailed comments on proposed Principles:

Principle 1

The responsible entity should draw up an effective liquidity risk management process, compliant with local jurisdictional liquidity requirements

We agree on the principle that the responsible entity should assess liquidity aspects at early stage during the pre-launch phase taking into consideration the liquidity of all types of instruments in which the CISôs assets will be invested, and this should be consistent with

CISös ability to comply with redemption obligations and other liabilities and this taking into consideration the CISös Liquidity profile (Gradual mechanism).

We have nevertheless one remark related to the footnote that states that ***ñ****in the case where a certain percentage of the CIS****ô****s assets must be kept in a certain type of liquid instruments, the responsible entity****ô****s systems should be appropriate to ensure that percentage is adhered to at* ***all timesò***. We believe that even if the objective is to respect the percentage at all times, in practice the liquidity cushion has to be able to play its role when needed.

Taking for instance money market funds, European guidelines do not require such a cushion; however our members already do it in practice on an individual basis. As an association, we propose that European regulation may require such a liquidity bucket so as to harmonise practices for money market funds. Nevertheless, for the rule to be efficient, we believe two conditions are to be met:

- **Eligible assets related to the instrumentsô maturity**

  Daily monitoring by the risk department could be required. The liquidity cushion is to be monitored taking into account instruments that can be transformed in cash without uncertainty, therefore a common definition of liquidity has to be linked to the concept of maturity. Eligible instruments should mature / have callable features within 1 to 7 days: cash, overnight and less than 7 days maturity instruments and deposits, repos with a call at 7 days or less, money market funds.

- **Not a hard simplistic rule, but a one month moving average**

  We strongly believe that a hard rule to maintain a certain percentage is not appropriate. Indeed,

  - either funds suffer a real ñrunò of redemptions and in that case the liquid cushion should be that huge at all times and in normal course of business, that it is not worth managing such a fund;

  - or redemptions are part of the normal cycle in a MMF, but slightly higher than the managerös expectations and it would be highly inefficient to be forced to create liquidity by diluting remaining investors instead of using a portion of the existing cushion. If the cushion is there, the calculation rule should be calibrated enough so as to avoid investors to lose additional performance along the non-compensation for the lack of performance due to the constitution of the cushion.

  We believe the weight of the liquidity bucket depends on the mix of measures each fund has put in place depending on its asset liability pattern. MMFs may however be required to hold a minimum level of liquidity measured as a **one month moving average** of 10%-15% with instruments maturing in less than 1/7 day. A temporary difference should be acceptable if the liquidity bucket is used to meet a redemption that causes the fund liquid assets to fall below the liquidity ratios.

AFG has a second remark related to the term ñvaried market conditionsò. We propose to modify it to ñnormal market conditionsò, as markets are more volatile and less stable than they used to be.

A third remark pertains to the 5th paragraph of the Principle 1. It is important for our members to recognize the existence of the different factors that are outside the control of the operator. The liquidity of the types of instruments in which the CIS invests its assets is not precise enough. Equity is a type of instrument, yet some equities can be illiquid. If one sets up a proper liquidity risk management, one has to take into account the strategy of the CIS, and not general definitions of instruments. Consequently, no responsible entity can ñensureò as expressed in that paragraph. The only possible achievable aim is to ñseek to ensureò the required results. AFG would also highlight the need to consider a global approach to the CIS obligation. For instance, one can, for example, have some illiquid investments provided that, as a whole, the CIS is able to meet its obligations.

Principle 2

The responsible entity should set appropriate liquidity limits which are proportionate to the redemption obligations and liabilities of the CIS

AFG strongly believes that Principle 2 should allow a wider range of liquidity risk management approaches including qualitative measures. As currently drafted (ñlimitsò), the principle is not applicable to all CIS.

Imposing a minimum liquidity requirement in the industry would permit harmonisation on all CIS regarding liquidity requirements if managing MMFs. Thus, hard (quantitative) liquidity limits are adequate for certain type of funds (MMFs) only, not for other types of CIS.

AFG recommends that the Principle and accompanying commentary rather uses the language ócriteria or thresholdsô than ólimitsô. The focus of the Principle should be on the need to set criteria and thresholds that trigger deepened analysis and/or action. Liquidity management requires above all the application of a **qualitative analysis**. The Principle should therefore focus on the expectation that the responsible entity should have a qualitative review process that may integrate or not quantitative thresholds.

Consequently, AFG believes that across Principles, the word ñlimitò should be replaced by "**criteria or thresholds**", which is not as binding and stringent and opens the door for a more qualitative, flexible and fine-tuned assessment. Thus, to be applicable, the principle should be amended as follows: *The responsible entity should set appropriate liquidity **criteria or thresholds** ~~limits~~ which are proportionate to the redemption obligations and liabilities of the CIS.*

It should be added that all UCITS managers are required to employ an appropriate liquidity risk management process in order to ensure that the funds they manage are able to meet redemption requests from investors. This liquidity risk management process is part of the permanent risk management function that UCITS management companies must establish which must be functionally and hierarchically independent from other departments within the management company. Managers are required to measure and manage the risks to which the fund is or might be exposed, including the risk of massive and unexpected redemptions.

Setting a robust liquidity risk management process should be the priority as in matters of liquidity being able to have a global view and to adapt to changing market environment are key.

Principle 3

The responsible entity should carefully determine a suitable dealing frequency for units in the CIS

We agree with this Principle.

We understand by suitable dealing frequency the redemption conditions package that permits investors to exit the fund (for instance: dealing day coupled with all restrictions such as notice periods, gates, redemption fees, etc).

Principle 4

Where permissible and appropriate for a particular CIS, and in the interests of investors, the responsible entity should include the ability to use specific tools or exceptional measures which could affect redemption rights in the CISôs constitutional documents

We agree in general with the principle of disclosure; however we believe that full disclosure before any use is not always applicable in practice.

UCITS vs hedge funds

Regarding equality of treatment, UCITS/mutual funds do not operate in the same manner to hedge funds. Indeed, hedge funds have mechanisms such as multi-series accounting or equalizations (depreciation deposit / equalisation credit / equalisation share).

Also, sometimes Side Pockets are used by the hedge fund manager as a style of management in order to differentiate specific investments one from the other.

Our members believe that Side Pockets may be adapted or not, depending on the strategy and / or asset classes. It is more relevant for strategies such as small caps/convertibles/high yield/fixed income.

The more liquid-type is the vehicle, the less appropriate are the redemption restrictions. For instance, for UCITS, that have at least fortnight redemption windows, other measures may be more appropriate (bid pricing; swing pricing, variable entry fees acquired to the fund, etc). Our members believe that Side Pockets, gates, in kind, etc. are very exceptional operations tools for UCITS. Side Pockets may be used in the context of liquidation or in exceptional conditions. Conversely, a *price* solution is more adapted in the case of on-going activity.

MMFs are highly liquid-type vehicles; our members think redemption restrictions are not appropriate tools.

We believe valuation and liquidity are interlinked issues and the more marked to market the vehicle, the less asset liability matching problems arise. For instance, for MMFs, VNAV MMFs pass market risk onto investors that are aware of their investment risk profile. They can exit/stay/enter the fund at all times, contrary to a CNAV fund where breaking the buck is a cliff effect event.

We remind that funds in Europe can suspend subscription and/or redemptions if case of serious market stress.

Principle 5

The responsible entity should consider liquidity aspects related to its proposed distribution channels

AFG believes this Principle is very difficult to put into practice, especially before the marketing period. One single fund can be sold through many different channels of various size and different marketing period. It may however be dealt afterwards, once distribution channels are in place.

ñKnow your clientò is not always very easy to do in practice, especially for networks distribution.

We believe that this principle should be amended: *The responsible entity may consider liquidity aspects related to its proposed distribution channels,* ***if relevant and where available****.*

Principle 6

The responsible entity should ensure that it will have access to, or can effectively estimate, relevant information for liquidity management

The wording of Principle 6 should recognise that it is not possible to *ensure* such an outcome. There will also be circumstances where it is not possible to ensure effective estimation of liquidity as liquidity risk management in CIS is a complex area and poor liquidity may arise from many different sources, some of which are outside the control of the entity operating the CIS.

We therefore recommend that the Principle be amended as follows: *The responsible entity should* ***seek to*** *ensure that it will have access to, or can effectively estimate, relevant information for liquidity management.*

The accompanying commentary to Principle 6 should also reflect the abovementioned constraints.

Principle 7

The responsible entity should ensure that liquidity risk and its liquidity risk management process are effectively disclosed to prospective investors

AFG believes that only relevant, comprehensible and parsimonious information should be disclosed. Lengthy exhaustive information dissemination would not be useful and may even become to be misleading. Indeed, as we have already mentioned before, flexibility is a key concept in matters of liquidity management and dissemination of information should not capture parameters that are susceptible to change.

Our members believe that disclosing internal limits to clients is not a relevant measure. Internal limits and breaches are the managersô day to day business and need the necessary flexibility. There may be of course disclosures related to one to one diligence with clients, but on a discretionary and non systematic basis. Indeed, the contrary would mean that there are no more ñinternalò limits but only opposable external limits, which would lack the needed responsiveness.

Disclosure requirements must be understood in such a manner that only a summary of the general implemented liquidity process for all funds have to be disclosed.

AFG recommends that this information be given in the prospectus. Basic day-to-day liquidity information is already in the KIID and prospectus.

We therefore recommend that the Principle be amended as follows: *The responsible entity should ensure that* ***the CISôs offering documents provide relevant information*** *on liquidity risk and its liquidity risk management process.*

<u>Day-to-day Liquidity Risk Management Principles</u>

Principle 8

The responsible entity should effectively perform and maintain its liquidity risk management process

We agree.

Principle 9

The responsible entityôs liquidity risk management process must be supported by strong and effective governance

We agree. However, it is very important that the last phrase regarding the *independent oversight* should specify **ñif relevantò**, as the pertinence of the provision depends on the strategy (it could make sense for real estate for instance, but not for many other cases). To ensure risks are managed as a whole, the liquidity risk management process should be integrated in the global risk monitoring of the CIS and follow the risk escalation procedure.

Principle 10

The responsible entity should regularly assess the liquidity of the assets held in the portfolio

As the Principle refers to the need to regularly assess liquidity, for consistency, AFG proposes to amend the proposed Principle 10, stating that ñregularlyò should replace the word ñcontinuouslyò in the first line of this paragraph. The change also recognises the principle of proportionality. Frequency of the monitoring and the review of compliance of the rules can be tailored to the characteristics of the fund concerned.

To be aligned with the proposal made in Principle 2, AFG also suggests that ñcriteria and thresholdsò should replace the word ñlimitsò for the reasons given in comments relating to Principle 2.

Principle 11

The responsible entity should integrate liquidity management in investment decisions

AFG considers that it is not possible to know with certainty what impact future events might have on a holding. The requirement mentioned in the 1st paragraph under Principle 11 should be for investment managers to keep such investments under review.

Considering the **paragraph** related to **collateral** under Principle 1, we consider it should be **deleted** as not related to the matter discussed in this Consultation. This consultation deals with the requirement to manage the liquidity of the fundôs investment portfolio (asset side) so that the CIS can meet its investor dealing obligations. Collateral is part of the collateral management process and not of the liquidity risk management process, so there is no actual need to require liquidity risk management for collateral in this document.

Additionally, collateral received by a fund is not part of its investment portfolio; rather it is held to mitigate a different type of risk: counterparty risk. Responsible entities generally have a separate collateral risk management process in place.

In any case, in Europe, asset managers are expecting to see provisions linked to EMIR which will highly impact collateral linked matters.

Principle 12

The liquidity risk management process should facilitate the ability of the responsible entity to identify an emerging liquidity shortage before it occurs

We agree with this principle as long as we maintain the sentence ñin normal circumstances, the CIS will be able to meet redemption requestsò.

We appreciate the reference to the fair treatment of investors as for collective investment schemes, this principle should be clearly reaffirmed as fundamental.

We believe that the ñindirect factorò example given under the 3rd paragraph of the Principle is no relevant and should be deleted. Usually, except for index funds, a performance decrease is not systematically linked to a problem of risk (i.e. of the failure of an asset of the CIS). A provision which would oblige to reduce the risk in case of such lack of performance would have a vicious circle effect because it would further damage the performance of the fund.

Principle 13

The responsible entity should be able to incorporate relevant data and factors into its liquidity risk management process in order to create a robust and holistic view of the possible risks.

AFG would like to raise the fact that the development and use of scenarios relating to the behaviour of investors is very time consuming and the end result may not be conclusive. From an operational perspective, it will be difficult to comply with this requirement for large asset management companies with many retail funds and multiple sales and distribution partners. Liability statistical analysis is adapted to MMFs (cyclicality of institutional investors) but it would not make sense for the great majority of CIS.

We query the need for this Principle. Indeed, Principle 1 already requires that an effective liquidity risk management process is put in place. We believe this renders Principle 13 redundant. Relevant parts of the accompanying commentary could be included under Principle 1.

Principle 14

The responsible entity should conduct assessments of liquidity in different scenarios, including stressed situations

As expressed for Principle 11, AFG is of the opinion that the monitoring of collateral liquidity is very important. However, it should be clarified that an assessment to demonstrate that the quantity of liquid assets is sufficient to meet settlement of margin calls on derivatives positions and should not necessarily be part of the (liquidity) risk management. In any case, in Europe, asset managers are expecting to see provisions linked to EMIR which will highly impact collateral linked matters. By the way, currently one cannot model liquidity costs for OTC because of the lack of data, for example on volumes.

In theory, stress scenarios are a very attractive tool, however in practice, it is neither always feasible nor relevant. Our members believe, after the 2008 crisis experience, that a pragmatic approach should be privileged. For instance, quantitative methods are not adapted for fixed income liquidity, which need a more case by case qualitative approach such as expertsô appraisals. In addition, selling flows techniques are not the same for bond portfolios versus MMFs because of the duration objective.

We thus propose the Principle be amended as follows: *The responsible entity should conduct assessments of liquidity* ***if relevant*** *in different scenarios, including stressed situations.*

Principle 15

The responsible entity should ensure appropriate records are kept, and relevant disclosures made, relating to the performance of its liquidity risk management process

It is not clear to whom disclosures are to be made (potential investors, existing ones?) and which would be the benefit of such a disclosure (ie on the ñ**performance**ò of the liquidity risk management process). By the way, how to measure the performance of a process?

We are concerned that it could bring confusion and even amplify liquidity risk. Indeed, one has to think about specific market conditions where volatility is high, and where the CIS would be forced to repeatedly communicate to investors, increasing again confusion and volatility. We want to highlight that this kind of reporting needs to be confidential and would be dedicated to regulator only.

For example, there could be a material change in liquidity which leads the operator to make use of existing and disclosed normal liquidity management tools. If the operator had to inform investors in these circumstances, such action could lead to a run on redemptions which in turn negatively impacts the CIS. AFG however agrees that where an exceptional measure, such as suspension, is implemented, investors should be notified. For the sake of clarity, EFAMA would however recommend to define the notion of ñexceptional measuresò.

We, consequently, recommend that the Principle be amended as follows: *The responsible entity should ensure appropriate records are kept relating to the practice of its liquidity risk management process, and relevant disclosures be made to the regulator relative to exceptional measures impacting the dealing policy.*

If you need any further information, please donôt hesitate to contact Eric Pagniez, at +33.1.44.94.94.06 (e.pagniez@afg.asso.fr) or Adina Gurau Audibert, at +33.1.44.94.94.31 (a.gurau.audibert@afg.asso.fr).

Sincerely Yours,

(signed)

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