September 4, 2023

Mr. John Schindler
Secretary General
Financial Stability Board (FSB)
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland
(Submitted electronically)

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

Dear Mr. Schindler:

The Institute of International Finance (IIF)[1] and its members are pleased to respond to the Financial Stability Board's (FSB) Consultative Document on *Addressing Structural Vulnerabilities from Liquidity Mismatch in Open-Ended Funds – Revisions to the FSB's 2017 Policy Recommendations* (Consultative Document). The purpose of this Consultative Document is to set forth recommendations intended to incorporate lessons learned since 2017 (the 2017 Recommendations)[2] and to aim to enhance clarity and specificity on the intended policy outcomes to make the recommendations more effective from a financial stability perspective. The proposals build on the FSB's December 2022 report on the Assessment of the Effectiveness of the FSB's 2017 Recommendations on Liquidity Mismatch in Open-Ended Funds (FSB Assessment)[3].

The International Organization of Securities Commissions (IOSCO) has issued a complementary consultation report on guidance on anti-dilution liquidity management tools (LMTs) (IOSCO Consultation) [4] to which the IIF will respond separately.

Background

Open-ended funds (OEFs) serve key roles in financial markets, contributing to market diversity and resiliency, and providing funds that finance the real economy. OEFs are well regulated and monitored on a regular basis by securities regulators. They generally are well governed internally.

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[1] The Institute of International Finance (IIF) is the global association of the financial industry, with about 400 members from more than 60 countries. The IIF provides its members with innovative research, unparalleled global advocacy, and access to leading industry events that leverage its influential network. Its mission is to support the financial industry in the prudent management of risks; to develop sound industry practices; and to advocate for regulatory, financial, and economic policies that are in the broad interests of its members and foster global financial stability and sustainable economic growth. IIF members include commercial and investment banks, asset managers, insurance companies, professional services firms, exchanges, sovereign wealth funds, hedge funds, central banks, and development banks.

[2] https://www.fsb.org/wp-content/uploads/FSB-Policy-Recommendations-on-Asset-Management-Structural-Vulnerabilities.pdf

[3] https://www.fsb.org/wp-content/uploads/P141222.pdf

[4] https://www.iosco.org/library/pubdocs/pdf/IOSCOPD739.pdf.

Fund failures are rare and largely idiosyncratic and to date have not given rise to material systemic consequences.

Policymaker concerns about the systemicity of OEFs may arise from generalized concerns about the impact on financial stability of the activities of the much broader non-bank financial intermediation (NBFI) sector. However, policymakers should consider the considerable diversity in activities and risk in the NBFI sector and should refrain from applying broad recommendations across the entire NBFI sector. Rather, any such recommendations should be carefully tailored to the risks that may be posed by a particular subsector.

In particular, in terms of priority, the FSB should consider the financial stability implications of activities in the unregulated segments of the NBFI sector, as well as how risks arising from those unregulated activities can be transmitted through interconnections among unregulated NBFIs and other financial institutions. We encourage the FSB to address those risks through targeted measures directed at unregulated institutions, rather than indirectly through the imposition of additional measures on regulated entities.[5]

General Comments

The proposed changes to the 2017 Recommendations should be less prescriptive

The IIF generally supports the goals of the Consultative Document in making the 2017 Recommendations more effective from a financial stability perspective. However, we find the proposed approach to achieving those goals in some respects unduly prescriptive. We discuss several of the FSB's recommendations in greater detail below.

We find in particular a disproportionate level of prescriptiveness in Recommendation 5, which addresses the use of LMTs by OEF managers. We encourage the FSB to consider aligning its approach to LMTs more closely to the approach proposed in the IOSCO Consultation.

The proposed approach in the IOSCO Consultation would provide greater discretion to responsible entities and their managers to take appropriate actions to address investor dilution and potential first-mover advantage arising from structural liquidity mismatch in OEFs. As noted in the IOSCO Consultation, "[r]esponsible entities have the primary responsibility and are best placed to manage the liquidity of their OEFs. As such, the proposed guidance neither prescribes a specific calibration for each anti-dilution LMT nor specifies which tool should be used or when." While the FSB does express its belief that OEF managers have the primary responsibility and are best placed to manage the liquidity of their portfolios (Section 3.1), we respectfully suggest that this view should be reflected in a less prescriptive approach in the final recommendations.

[5] We note that, in some cases, the FSB could distinguish more clearly sources of financial market stress from unregulated segments of the NBFI sector. For example, this distinction could have been made more clearly in the FSB's November 14, 2022 *Final Report on Financial Policies in the wake of COVID-19: supporting equitable recovery and addressing effects from scarring in the financial sector*: https://www.fsb.org/wp-content/uploads/P141122.pdf and its November 10, 2022 *Progress Report on Enhancing the Resilience of Non-Bank Financial Intermediation*: https://www.fsb.org/wp-content/uploads/P101122.pdf.

In making any changes to the 2017 Recommendations, the FSB should recognize the diversity of the OEF industry across jurisdictions

In finalizing the recommendations, the FSB should recognize the considerable diversity in the level of sophistication of the OEF industry across the many jurisdictions in which these funds are organized. Jurisdictional differences can include overall OEF market structure, the level, quality and timeliness of available market data, the ability to operationalize LMTs, and regulatory and supervisory capacity.

The IIF strongly advocates for measures that minimize and reduce the considerable risks of regulatory fragmentation[6], while recognizing that, to some extent, different requirements may be needed to reflect market and industry specificities in a particular jurisdiction. Fragmentation increases the fragility of markets, with implications for financial stability and systemic risk, and may limit cross-border trading opportunities. Fund managers often incur financial and operational inefficiencies and additional costs as a result of unnecessary and excessive fragmentation. The combined impact of market fragmentation across jurisdictions undermines the efficiency, effectiveness, and resilience of the global financial system as a whole.

Where regulatory fragmentation cannot be easily and readily addressed, the FSB should encourage its members to adopt interoperable frameworks for OEF regulation and supervision, with mutual recognition of regulatory and supervisory regimes. In addition, enhanced home-host cooperation and information sharing could help to mitigate some of the negative impacts of regulatory fragmentation.

Comments on the Recommendations

Concerns about unanticipated consequences from the disclosure of detailed information should be further explored (Recommendation 2)

The IIF supports the disclosure of accurate, timely and decision-useful information on fund liquidity, liquidity risk and the availability and use of LMTs to investors and prospective investors in OEFs (Recommendation 2). As noted in the discussion of Recommendation 2, disclosure requirements should be proportionate to the benefits that they bring to investors about liquidity transformation in OEFs individually and in the aggregate and should help investors clearly differentiate between different types of funds and their liquidity risks. We fully support the disclosure to investors of information that allows them to understand the range of actions that fund managers may take in order to address fund liquidity needs, particular in times of market stress.

However, we encourage the FSB to consider more fully the potential unanticipated consequences of public disclosure of certain detailed fund information. As recognized in Section 3.2, detailed fund information can be used by professional traders to engage in predatory trading strategies that disadvantage the fund and remaining fund shareholders, many of whom may be retail investors. Moreover, predatory trading or herding behavior can have negative destabilizing consequences that extend far beyond an individual fund or group of funds to the market as a whole. Moreover, other information, such as detailed fund strategies and positions, may be highly

[6] https://www.iif.com/portals/0/Files/content/32370132_iif_scer_market_fragmentation_vf_03_02_2023.pdf

sensitive and proprietary and their disclosure could also incentivize predatory behavior, such as ‘front running’ fund trading or reverse engineering strategies to inform trading activities.

A more proportionate and risk-based approach to disclosure would allow OEF managers and compliance officers to balance the risks of unanticipated consequences with the need to meet the needs of investors for accurate, timely and decision-useful information by focusing disclosures on the information that investors need in order to make informed investment decisions that reflect their risk appetite and risk tolerance.

The Bucketing Approach Should Be Reconsidered (Recommendation 3)

The bucketing approach to categorizing OEFs into three main categories based on their liquidity (Recommendation 3) is subjective and arbitrary, implies a certain level of precision that is misleading, and would introduce considerable complexity in practice. Fund liquidity risk management is a dynamic exercise that reflects that the liquidity profile of a fund may change suddenly, especially in stressed market conditions. A restrictive bucketing approach would cause confusion among fund investors (particularly retail investors) that would be subject to rapid changes in dealing frequency and notice and settlement periods, as well as affected by the imposition of LMTs, in some cases without adequate time to adjust to the impact on their portfolios.

Importantly, and as elaborated below, the role of the fund manager in addressing changes in market liquidity is critical and may be unduly circumscribed by a rigid bucketing approach. Fund managers should be empowered to leverage their market expertise and take the actions necessary to keep the funds under their management on a sound and stable footing under a wide variety of market conditions, including through the use of LMTs when, and to the extent, warranted.

Fund managers should retain the discretion as to whether and when to deploy LMTs that they select (Recommendations 4 and 5)

Fund managers have the fiduciary duty to manage the liquidity risks of their funds and to meet their obligations to investors. Fund managers also are best placed to manage the liquidity risks of their OEFs and to determine whether the use of one or more LMTs would be an optimal method of managing those risks. We agree that authorities should ensure that a broad set of LMTs and measures is available to OEF managers, but the decision as to whether to deploy one or more LMTs and the timing of the use of LMTs, as well as the calibration of a particular tool, should remain with the fund manager.

Regulatory imposed measures impair the ability of fund managers to meet those obligations and to take appropriate steps that are based on their experience and expertise rather than on one-size-fits-all approaches or tools that are unlikely to reflect the economics of the fund under current market conditions. LMTs should be employed if and when, and to the extent that fund managers deem appropriate.

Moreover, the FSB should consider the market structure and operational challenges associated with the use of certain LMTs in some jurisdictions and reflect these challenges in flexible and non-prescriptive recommendations and guidance. For example, the use of swing pricing in some countries would give rise to significant operational challenges and resistance from market participants that may impose costs that would be disproportionate to the benefits of using this tool. In other jurisdictions, swing pricing is effectively deployed as an LMT. The FSB should acknowledge that the choice of whether and when to deploy an LMT and the choice of tool is dependent in part on these market differences.

Recommendation 5 is disproportionately prescriptive. Moreover, the challenges to OEF managers of estimating the costs of liquidity should be fully addressed (Recommendation 5)

Consistent with our comments with respect to Recommendation 4, OEF managers should have the discretion as to whether, when and how to deploy LMTs if they decide that the use of one of more LMTs would be appropriate and consistent with the best interests of investors. Recommendation 5 should be reworded in a less prescriptive manner in order to reflect that OEF managers are best placed to manage the liquidity of their funds, as the FSB and IOSCO have both acknowledged.

The FSB should more fully consider the challenges to fund managers of estimating the explicit and implicit transaction costs of subscriptions or redemptions, including market impacts, particularly in times of market stress (Recommendation 5). Data limitations make it difficult to include with a high level of precision or confidence market impacts in the calculation. Moreover, relying on past transaction data to estimate the market impact of purchases and sales needed to meet current investor subscriptions or redemptions, particularly in times of market stress, does not ensure that market impacts will be properly estimated for future transactions.

Recommendation 5 should be amended to reflect that an estimate of explicit and implicit costs would be made on a best-efforts basis and that, on a best-efforts basis, LMTs should impose on redeeming and subscribing investors the explicit and implicit costs of redemptions and subscriptions.

The regulatory and supervisory usefulness of system-wide stress testing should be further explored (Recommendations 6 and 9)

We encourage the FSB to engage further with the industry with respect to the usefulness of system-wide stress testing exercises in the regulatory and supervisory monitoring of OEF liquidity before finalizing Recommendations 6 and 9.

While the results of individual OEF stress testing can produce information that is useful to jurisdictional regulators and supervisors, we do not believe that global system-wide stress testing would produce meaningful insights. Results that are aggregated on a system-wide basis would not be likely to produce meaningful insights given the different levels of liquidity and leverage across different types of OEFs. In addition, collecting the data for the effective performance of such stress testing would be very challenging, if not infeasible for some data points.

Global system-wide stress testing may also conflate and confuse the roles of macroprudential regulators and securities regulators. The roles, responsibilities, and competencies of the two sets of regulators are complementary but quite different and, while coordination among the authorities should be encouraged, their work should reflect their respective competencies.

Conclusion

We appreciate the opportunity to comment on the Consultative Document. We thank the FSB for its consideration of our comments, and we would welcome additional stakeholder engagement around this important topic. If you have any questions or would like to discuss our comments in greater detail, please do not hesitate to contact Martin Boer at mboer@iif.com or Mary Frances Monroe at mmonroe@iif.com.

Respectfully submitted,

Mary Frances Monroe