

THE INVESTMENT TRUSTS ASSOCIATION, JAPAN

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Secretariat of the Financial Stability Board,
c/o Bank for International Settlements,
CH-4002, Basel, Switzerland

Dear Sir/Madam,

Re: Proposed Policy Recommendations to Address Structural Vulnerabilities
from Asset Management Activities

I. Preface

The Investment Trusts Association, Japan (hereafter, "JITA") appreciates the opportunity to provide these comments in response to the Consultative Document, "Proposed Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities" which was made public on June 22nd, 2016.

JITA was established in July 1957 under a license of the Minister of Finance, which was the governing authority at that time, for the purposes of protecting investors and promoting sound development of investment trusts in Japan. JITA is positioned as 'Authorized Financial Instruments Firms Association' under the Financial Instruments and Exchange Act of Japan, and the purposes and the scope of business of JITA are defined by the Act. JITA comprises of 171 full members including investment trust management companies and REIT management companies as well as 21 supporting members including securities companies and custodian banks as of September 2016.

We, JITA, would like to express our comments regarding the Consultative Document.

II. Comments on the Consultative Document:

1. Fundamental idea on liquidity risk management

The mission of investment funds is to respond to investors' need for long-term asset building by diversifying risks associated with their investments. In fulfilling its mission, investment funds should have a robust risk management system to keep the liquidity to an adequate level in order to respond to the redemption need of investors while managing the assets most effectively to aim at asset accumulation for investors.

In considering the relationship between liquidity risk management of investment funds and the stability of the financial system, a variety of elements should be taken into consideration. For example, we should consider short-term funds such as MMFs separately from long-term funds, or the funds whose investment strategy is based on a longer time horizon. It might be said that the short-term funds such as MMFs would have more direct connection with the stability of the financial system through their connection with the payment systems, therefore theoretically requiring closer attention to their systemic implications. However, in the case of longer-term oriented funds, it is uncertain whether their liquidity issues could always pose a systemic threat to the stability of the financial system. The appropriate liquidity risk management approach would depend on the investment strategies and risk taking policies of individual funds. Accordingly, it is important to consider this issue by scrutinizing the recent cases. We should carefully study how the liquidity problems did or did not spread or threaten the stability of the financial system and explore approaches so that any rules designed to manage liquidity risks would not harm the sound function of the financial markets.

The purpose of contemplating regulatory measures to ensure appropriate liquidity management should also need to be clarified, namely, whether such measures are intended for maintaining the function of the financial system and preventing systemic risks, or whether such measures are intended to preserve the confidence of investors in their ability to redeem their assets. In the latter case, it is important to reflect on the characteristics of each fund and assure the investors to be treated equally and fairly. If a regulatory approach are to be taken to apply uniformly to any types of funds, such an approach might erode the confidence of the investors in the funds as their right of redemption might be viewed as unfairly eroded.

The Japanese publicly-offered investment trusts have not experienced a case in which liquidity problems caused systemic risks. The Japanese investment trust industry and self-regulatory organizations, including JITA, have built up the fund management system taking into consideration the need to ensure stability

and liquidity of funds. Specifically, the Japanese investment fund industry traditionally has paid intensive attention to the liquidity of funds in launching fund products.

2. Reporting fund liquidity profile to the regulatory authority (Recommendation 1, 7)

Collecting data on funds' liquidity risk profiles is important for regulators to grasp the potential sources of systemic risks and to prevent a possible crisis. However, as mentioned above, the liquidity profile information needed of funds will vary according to the purposes of collecting such information. If the purpose is for macro-prudence policies and for preserving the stability of the financial system, it is probably more important to pay attention to the asset classes in which the funds invest than to the liquidity profiles which can change significantly when prices of a certain asset class change drastically.

Besides, it is important to note that from a viewpoint of fiduciary duty of fund managers to their investors, the liquidity risk profile of funds can differ greatly from fund to fund, as the investment strategies and targeted investors of various funds are widely diverse. In order to deal with the systemic risk problem, it would therefore be important to pay attention also to investor profiles, or liability side of funds' balance sheet.

In certain jurisdictions, such as Japan, it may not be easy for asset managers to grasp investor profiles due to the separation of asset management and distribution businesses.

For these reasons, introducing uniform measures to capture the liquidity risk profile may not prove particularly useful. While uniform measures to capture the liquidity risk profiles may be useful for certain regulatory or policy purposes, even in such cases, caution would be required in directly translating the results derived from the collected information into actual policy measures because risk profiles and compositions of asset class vary from fund to fund. A clear criterion should be established and communicated if the risk profile information should be collected by a uniformed measure.

3. Disclosure of the fund liquidity profile to investors (Recommendation 2)

It would be possible to consider requiring asset managers to disclose their liquidity risk management policies as one of the regulatory measures. But careful consideration would be needed, as the intended purpose of liquidity risk management by regulatory authority, namely, ensuring the financial market to function effectively and preserving financial stability, could be undermined by ill-designed disclosure requirements. Even if the purpose of the disclosure of the results is to deter the run by the investors, information asymmetry among investors might possibly bring about arbitrage opportunities by certain investors, creating inequality among them. Disclosing complicated information could also cause misunderstandings among fund investors under the circumstances of turmoil in the financial market, possibly exacerbating systemic crisis eventually.

Although it is important to require each asset manager to draw up clear procedures regarding the use of liquidity risk management tools in advance, careful consideration would be needed if disclosure of these procedures are to be made to investors, because putting the tools into practice would ultimately hinge upon judgement of responsible entities under stressful actual market conditions which can vary and cannot be predicted in advance.

4. Points to remember at the design phase of fund products (Recommendation 3)

In Japan, asset managers, when launching an investment trust, prescribe liquidity measures and the related conditions for suspension and redemption in the trust deed with careful consideration of the characteristics of asset classes in which investment will be made. They also prescribe an upper limit on the amount of asset classes within the fund. In this way, they are expected to make best efforts to reduce the liquidity risk by fitting together the redemption condition and the availability of the liquidity of the fund at the design phase of investment funds.

Managing liquidity risk of an investment fund by carefully assessing such risk at its designing stage is an important and effective practice. It is important that regulators and individual asset managers can select most appropriate risk management tools, depending on each economy's legal and regulatory system and on each product's characteristics.

5. Status of utilization, procedure in using and issues to be considered on liquidity management tools
(Recommendation 4)

In Japan, available liquidity management tools for asset managers include redemption gate, suspension of redemption and anti-dilution fee which investors are required to leave to the fund in case of their redemption. These tools should be recognized as liquidity management tools. Other measures could be included as additional tools, if they prove effective and practical.

As to the swing pricing, it could be one of the reasonable liquidity management tools. However, caution would be needed to introduce it as a uniform tool, because in the case of the investment funds in which variety of investors participate, the adoption of this tool could undermine the principle of treating all investors fairly, depending on legal system or business practices in some jurisdictions.

As mentioned above, because availability or effectiveness of each liquidity management tool would differ according to the characteristics of individual fund as well as to the regulatory system in each jurisdiction, it is reasonable to introduce a variety of liquidity risk management tools and to permit asset managers to select the most suitable one for their funds, instead of introduction of uniform tools which will be applied to all funds.

6. Risk management tools for the First Mover Advantage
(Recommendation 5)

In the cases where First Mover Advantage could occur, it may be impossible for asset managers or funds to completely avoid inequality among investors if they respond individually. In such cases, it would be reasonable for a regulator to introduce a uniform tool applied to all market participants for the purpose of maintaining financial market stability and preserve the function of financial markets. And then, if the individual asset manager should introduce management tools on their own discretion, following points might be worth mentioning.

In Japan, the anti-dilution fee, as mentioned above, is available. It functions as a disincentive for investors to redeem their funds. The limitation on the amount of redemption can also be set in advance by asset managers according to a self-regulatory rule of JITA. It is also possible for fund managers to request fund distributors to inform them of the large amount of redemptions from investors. These measures should be adopted as effective measures to address

the First Mover Advantage.

The redemption fee can also be effective to deter the First Mover Advantage to some extent, but the anti-dilution fee would be more effective for avoiding the panic because the redemption fee is considered as revenue of the distributor while the amount deducted as anti-dilution fee remains within the fund.

As to the countermeasure to the First Mover Advantage, it is important to permit the variety of options for the fund managers, rather than introducing uniform measures.

In considering the liquidity risk management tools to deter the First Mover Advantage, it is important to note that ensuring appropriate mark-to-market valuation of assets in the fund is essential. In addition, we should carefully pay attention to the possibility that the introduction of liquidity risk management tools may open up the scope of regulatory arbitrage between regulated funds and those financial products which are out of the scope of the liquidity risk management regulation.

7. Regarding the stress testing (Recommendation 6, 9)

It is necessary to clarify the purpose of the stress testing (e.g. to control liquidity risk, to avoid the systemic risk in the capital markets, or to protect investors). Unless the purpose is clearly specified, it may not prove effective in gaining the appropriate response.

It should be noted also that a stress test cannot always deliver meaningful results if it is applied to all funds with diverse investment strategies and diverse investors.

The stress testing is dependent on certain hypothetical conditions and does not mean to predict actual market conditions or other important factors. Accordingly, treating the results of the stress testing should not be taken for granted as a clear indication of the general consensus.

Sincerely yours,

M. Shirakawa

Makoto Shirakawa
Chairman
The Investment Trusts Association, Japan