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Invested in America

| asset management group

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European Securities and Markets Authority (ESMA)
CS 60747
103 rue de Grenelle
75345 Paris Cedex 07 France

Re: Response to Consultation Paper
Draft guidelines on liquidity stress testing in UCITS and AIFs

The Asset Management Group (the "**AMG**") of the Securities Industry and Financial Markets Association ("**SIFMA**") appreciates the opportunity to provide comments to the European Securities and Markets Authority's ("**ESMA**") consultation on its draft guidelines on *Liquidity stress testing in Alternative Investment Funds* ("**AIFs**") *and Undertakings for the Collective Investment in Transferable Securities* ("**UCITS**")[1] (hereinafter "**draft guidelines**") .

The AMG is the voice of the buy side within the securities industry and broader financial markets, which serves millions of individual and institutional investors as they save for retirement, education, emergencies, and other investment needs and goals. The AMG's members represent U.S. asset management firms whose combined assets under management exceed $45 trillion.

The clients of SIFMA AMG member firms include, among others, tens of millions of individual investors, registered investment companies, endowments, public and private pension funds, UCITS and private funds such as hedge funds and private equity funds. While our members operate both inside and outside the United States and many are considered to be global enterprises, the background and orientation of our organization is rooted in U.S. laws and regulations.

The ESMA draft guidelines were issued in response to the recommendations by the European Systemic Risk Board ("ESRB") on liquidity and leverage risks in investment funds[2] intended to encourage a consistent approach in the use of liquidity management tools across the EU.

Under ESRB's Recommendation "C", ESMA was requested to develop guidance on the practice to be followed by managers with respect to stress testing of liquidity risk for AIFs and UCITS. The ESRB asked ESMA to provide guidance with respect to: (i) the design of Liquidity Stress Testing ("**LST**")

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[1] ESMA, *Consultation Paper: Guidelines on liquidity stress testing in UCITS and AIFs* (February, 2019) https://www.esma.europa.eu/sites/default/files/library/esma34-39-784_esma_guidelines_on_liquidity_stress_testing_in_ucits_and_aifs.pdf

[2] ESRB, *Recommendation on liquidity and leverage risks in investment funds* (April, 2018) https://www.esrb.europa.eu/pub/pdf/recommendations/esrb.recommendation180214_ESRB_2017_6.en.pdf?723f0fa99b1e8886e651e4950d2a55af

scenarios; (ii) stress test policy including internal use of LST results; (iii) considerations on both sides of the balance sheet; and (iv) the timing and frequency of LST.

Before turning to more detailed comments on the proposed guidelines, we would like to highlight that the EU UCITS and AIFM Directives, as well as the EU Money Market Fund Regulation ("**MMFR**") established a comprehensive regulatory framework providing fund managers and regulators with tools to address risks and ensure regulatory safety for investors.

In this context, it should be noted that fund managers must secure portfolios' liquidity in line with their fiduciary duty. An asset managers' role is to handle redemptions and other potential liquidity liabilities using risk management tools in line with the relevant regulatory requirements and the fund's documentation.

LST complements liquidity risk management tools by providing an important analytical input in terms of risk assessment. LST is already widely used by asset managers to identify funds that need further review and to inform contingency planning. A robust liquidity risk framework, including stress testing requirements, should be consistent and broadly promote diversified fund portfolios as well as reflect the multi-dimensional nature of liquidity risk management. While we highlight the importance of consistency of regulatory requirements with respect to liquidity risk management tools, we also stress the need to avoid a prescriptive, one-size-fits-all approach. Therefore, it is important that the LST guidance allows proportionate application of LST, reflecting different fund structures.

Against this background, we welcome that ESMA decided to adopt a principles-based approach and to ensure consistency in the supervisory practices across the EU through high-level LST requirements for investment funds.

We also welcome that the draft guidelines reflect certain aspects of the IOSCO Recommendations for Liquidity Risk Management for Collective Investment Schemes[3]. In particular, we appreciate the incorporation of Recommendation 14, which stipulates that stress testing arrangements should be tailored to the size, investment strategy, underlying assets and investor profile of the investment fund.

In the broader context of liquidity management tools, we also welcome that ESMA has not followed the ESRB recommendation "B", under which ESMA was asked to define a list of inherently less liquid assets. We welcome that ESMA did not choose a prescriptive approach based on a compilation of a list of illiquid asset types and decided to provide high-level considerations regarding LST in funds invested in less liquid assets.

In our view, the proposed guidelines will support the implementation of effective liquidity stress testing programs. In general, we support the format of the guidelines with the explanatory considerations, and agree with the adaptable frequency of LST as warranted, and the recommended approach as regards the use of LST during a fund's lifecycle.

Below, we provide more detailed comments suggesting possible clarifications and adjustments that should be considered in the guidelines. Overall, our response is structured based on the questions provided in the consultation paper. We would like to highlight some of the key concerns, on which we focus in our letter:

[3] IOSCO, *Recommendations for Liquidity Risk Management for CIS*, (February, 2018) https://www.iosco.org/library/pubdocs/pdf/IOSCOPD590.pdf

- Incorporation of investor behavior: We caution against the use of entirely assumption-based factors influencing investor behavior and using overly hypothetical presuppositions based on investor strategies, types and origins. We also note that the use of nominee names and distribution platforms appearing as omnibus accounts on the shareholder records of firms results in a lack of transparency that makes performing shareholder profile analysis in the manner envisaged by the draft guidelines very difficult to implement.

- Inclusion of closed-ended AIFs: We do not support inclusion of closed-ended AIFs in the scope, as these typically do not allow for substantial redemptions.

- Inclusion of Money Market Funds (**"MMFs"**) in the scope: We call for consistency with the international approach and argue that inclusion of MMFs in the scope of the draft guidelines is not necessary. MMFs already are subject to more prescriptive rules in the dedicated legislation.

- Specific features of Exchange Traded Funds (**"ETFs"**): ETFs issue and redeem their shares only in transactions with large market participants knows as "Authorized Participants" and otherwise trade on exchanges or over-the-counter. As such, their exposure to redemption risk is very different compared to UCITS or open-ended AIFs. In our view, this is not recognized in the draft guidelines.

- Specifying liquidation cost: We caution against using explicit reference to liquidation cost in the guidelines. Liquidation cost is inherent in the investment process; it is dynamic and difficult to model precisely ex-ante in stress testing. Nevertheless, when managers choose to liquidate assets, liquidation cost will be a key consideration, but rather as part of the playbook than a definitive report. Furthermore, there is currently no industry consensus on how to model liquidation cost.

- Setting liquidity limits as a result of LST: We suggest revising the language in the guideline 5d, which suggests that LST outcomes should be used to inform decision making regarding fund liquidity limits. We propose substituting "limits" with "thresholds", which are more appropriate for monitoring and decision making.

- Aggregated LST: Funds are managed differently, holding different positions with various time horizons and based on different strategies. We thus do not see value in aggregation of LST as proposed by ESMA.

Q1 What additional costs and benefits would compliance with the proposed Guidelines bring to the stakeholder(s) you represent?

Q4 What are your views on when the Guidelines should become applicable? How much time would managers require to operationalise the requirements of these Guidelines?

Q24 Do you agree with ESMA's Guideline that LST should be undertaken in all cases annually, but that it is recommended to undertake it at least quarterly, unless a different frequency can be justified? What is the range of frequency of LST applied on funds managed by stakeholder(s) you represent?

We agree that LST should be conducted on an annual basis (Guideline 4), and support the indication that managers shall have discretion to determine, whether more frequent LST is required (explanatory consideration 10). We note however that there appears to be an inconsistency of wording, referencing various frequencies in the guideline and the table in the explanatory considerations. We suggest that the table with the recommended frequency also clearly indicates that the LST should be undertaken annually.

We note that the cost-benefit analysis as well as the timing of the guidelines' application are linked to and depend on the frequency of LST. Should the guidelines require managers to put in place standardized repeatable processes to undertake or support LST, additional IT resources might need to be developed and tested. This process might take up to 18 months and prove to be costly for the industry. Furthermore, time would be needed for managers to undertake quantitative analysis work, define key risk indicators and internal limits as well as buy-in from partners. Also, internal policies and procedures may need to be adjusted and implemented, while the lack of market standards for some of the guidelines might prolong their implementation. To provide managers with sufficient time to ensure compliance, in our view, the guidelines should not be applicable earlier than 18-24 months after their adoption.

Q2 Do you agree with the scope of these Guidelines? Should certain types of funds be explicitly excluded from these Guidelines? Should MMFs remain in-scope of these Guidelines?

Money Market Funds have unique characteristics intended to preserve capital and provide short-term liquidity. They are regulated by separate legislation, principally the Money Market Fund Regulation ("**MMFR**")[4], which is designed to address financial stability concerns that arose during the global financial crisis. MMFs already are subject to more prescriptive stress testing requirements under the MMFR. We also note that MMFs have been excluded from the FSB policy recommendations on structural vulnerabilities from asset management activities[5]. For these reasons, it is, in our view, not necessary to include MMFs in the scope of these guidelines. ESMA should ensure as much consistency as possible, including with the global approach.

Similarly, with a view of ensuring consistency of the regulatory requirements internationally, closed-ended AIFs should also be excluded from the scope of the guidelines. Closed-ended funds generally do not allow for substantial redemptions.

As a matter of drafting, we note that the draft guidelines do not clearly indicate their territorial scope. We assume the intention in relation to alternative investment funds ("AIFs") is that the guidelines should apply to alternative investment fund managers ("AIFMs") regulated in the European Economic Area ("EEA") and should apply to all of an EEA AIFM's AIFs (i.e. both EEA AIFs and non-EEA AIFs). We would not support any extension of the guidelines to non-EEA AIFs with non-EEA AIFMs, even if the non-EEA AIFs are being marketed in the EEA.

Q3 Is additional clarity required regarding the scope of these Guidelines? Is additional clarity required regarding the meaning of 'nature, scale and complexity' of a fund? Are there circumstances in which it would, in your view, be inappropriate for a UCITS to undertake LST?

Q6 Do you agree with the proposed Guidelines? What amendments, if any, should ESMA make to its proposed Guidelines?

[4] Regulation (EU) 2017/1131 of the European Parliament and of the Council of 14 June 2017 *on Money Market Funds* https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32017R1131&from=EN

[5] FSB, *Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities* (January 2017) http://www.fsb.org/wp-content/uploads/FSB-Policy-Recommendations-on-Asset-Management-Structural-Vulnerabilities.pdf

In this section, we outline our suggestions for amendments to the guidelines and their explanatory considerations, which are not addressed by specific questions.

Under Guideline 3, "LST should demonstrate a manager has a strong understanding of the liquidity risks." Demonstrating strong understanding can be subjective and could result in different interpretations. The explanatory considerations could therefore describe how a documented framework with an outcome-based approach would meet the requirements of this guideline.

In our view, Guideline 5 on the use of LST outcomes should also address strengthening the ability of managers to liquidate positions with minimal dilution of remaining shareholders, while maintaining the fund's liquidity and investment profile. We further propose to add a clarification in point "c", under which the LST outcomes should "assist in investment decision making." It should be clarified that this is specific to liquidity concerns and does not address broader investment outcomes. Furthermore, we suggest revising the language in the point "d", under which LST outcomes should inform decision making on fund liquidity limits. Imposing a hard limit as a result of LST would be too constrictive. In our view, the concept of "limits" should be therefore replaced with "thresholds", which is more appropriate for monitoring of a fund's liquidity health and decision-making.

Guideline 7 recommends that LST should be adapted to each fund depending on its nature, scale and complexity. In our view, the explanatory considerations related to this guideline should clarify that it is acceptable to consider asset liquidity agnostic of which fund holds the assets. Concerning point "b" on assumptions regarding investor behavior, consideration of net redemptions is sufficient. Bearing in mind data limitations, gross redemptions could be considered in the context of investor concentrations and possible large redemptions.

Guideline 8 recommends that LST employs hypothetical and historical scenarios and reverse stress testing. The explanatory considerations provide examples of hypothetical situations to be considered on both the asset side (e.g. material increase of interest rates, widening of credit spreads, increased market volatility etc.) and the liabilities side (e.g. political risk, largest investor redemption, change of portfolio manager etc.) of the balance sheet. Regarding the use of scenarios, Guideline 7 specifies that the scenarios should always be "sufficiently severe, but plausible". We note that every fund manager may come with a different interpretation of "hypothetical" and that "sufficiently severe" could likewise lead to a variety of interpretations. The usefulness of tests' results in hypothetical situations can often be questionable, and should not lead to any automatic responses. As a result, we would encourage flexibility in letting firms design scenarios that are appropriate for the investment strategy and not be overly prescriptive in the manner, in which stress testing must be performed.

Q8 What are your views on the requirement to undertake reverse stress testing, and the use of this tool?

Q16 Do you agree with the requirement to reverse stress test items on the liabilities side of the fund balance sheet?

As recognized by IOSCO[6], reverse stress testing may not be appropriate for all collective investment funds. We do not see the added value of reverse stress testing, where a manager predetermines an outcome with regards to fund liquidity. One simply needs to perform regular stress testing based on reasonably foreseeable stressed market conditions and read the results backward. Formalized reverse stress testing seems redundant and unnecessary.

[6] IOSCO, *Recommendations for Liquidity Risk Management for CIS*, (February, 2018) https://www.iosco.org/library/pubdocs/pdf/IOSCOPD590.pdf

We propose to further elaborate the explanatory considerations to clarify that reverse stress testing can be accomplished also through:

(i) using liquidity thresholds that trigger further review; and

(ii) ensuring that a liquidity playbook outlines a process for contingency planning in case the fund would not be liquid enough to honor redemptions.

Q7 Do you agree with the proposed explanatory considerations regarding LST of fund assets?

Q10 Do you agree with ESMA's wording regarding the asset liquidation method used in the LST model? How would you describe the asset liquidation method used by you or the managers you represent?

Managers have a range of options in their liquidity management toolkits and should be able to decide, which method or combination of methods is most appropriate in a specific situation.

The explanatory considerations should acknowledge that in certain circumstances, managers must maintain the ability to adjust the risk profile of a fund based on market conditions and in line with the fund's mandate and disclosures. Furthermore, managers should maintain the flexibility to consider the trade-off between limiting liquidation costs and maintaining a fund's risk profile.

It appears that the draft guidelines require calculation of a specific liquidation cost. In our view, it should be clarified that the guidelines allow for an implicit consideration of the liquidation cost that does not warrant the calculation of a fixed amount or a fixed percentage. Nevertheless, the wording should preserve flexibility, in case a manager chooses to use a reasonably determined fixed number.

Q9 Do you see merit in providing further considerations for managers on the use of data relevant to asset liquidity, particularly in circumstances when data is scarce?

Guideline 9 on data availability limitations recommends in point "b" that managers avoid reliance on third parties' LST models. This seems to suggest that firms would not be able to rely on third party metrics, which could result in an unnecessary burden and customization that firms would have to take on.

Q13 Do you agree with ESMA's considerations on LST in funds investing in less liquid assets? What amendments should be made to the proposed wording? Do you think that ESMA should outline additional and/or specific Guidelines to be made in any other fund or asset types, such as ETFs?

With respect to the LST in funds investing in less liquid assets, we welcome that ESMA did not chose to prescribe a specific approach or to compile a list of illiquid asset types. Liquidity can change within any asset class, which itself can become more or less liquid, depending on wider market developments.

Regarding ETFs, we note that IOSCO[7] did not issue specific recommendations for ETFs. In our view, the guidelines should recognize that the redemption risk for ETFs is smaller than it is for other types of investment funds. ETFs issue and redeem their shares only in transactions with large market participants

[7] IOSCO, *Recommendations for Liquidity Risk Management for CIS*, (February, 2018) https://www.iosco.org/library/pubdocs/pdf/IOSCOPD590.pdf

known as "Authorized Participants," and the large majority of ETFs engage in such transactions on an in-kind basis. Therefore, investors' liquidity needs are satisfied through secondary market activity and through the actions of the Authorized Participants.

Q14 Do you agree with the considerations regarding LST on items on the liabilities side of a fund's balance sheet?

Q15 Do you agree with the considerations specifying the LST of redemptions and other types of liabilities may need to be considered distinctly, given a fund could potentially limit redemptions but not other sources of liquidity drain?

While we acknowledge that other types of liabilities do pose potential risks for funds, we note that the simulation of events such as margin calls, cash collateral reinvestment or counterparty default might be undermined by assumption-based considerations. It is difficult to predict future events, which could lead to inaccuracies.

Q17 Do you agree with the requirement to incorporate investor behaviour considerations into the LST model 'where appropriate'? Are there cases which you believe it would not be appropriate, and should these be detailed in these Guidelines?

The guidelines seem to suggest that managers can easily model investor behavior and that all the necessary information is widely available. As acknowledged by IOSCO[8], one of the key challenges in liquidity management is taking appropriate account of the uncertainty in the future investor behavior in both normal market conditions and in stressed markets.

We would therefore like to caution against the requirement to incorporate investor behavior considerations into the LST models. In particular, we do not support the recommendation to integrate investor categories, origins and strategies. Modelling of these factors would be based on arbitrary assumptions, which puts the usefulness of such exercise into question. For example, it is questionable how the probability of redemptions due to changes in the macroeconomic environment could be weighted. While managers do seek to understand their investors' behavior, it is more useful to incorporate such considerations in LST on the basis of historical patterns, rather than on the basis of entirely hypothetical assumptions about factors that are not easily modelled.

Furthermore, access to information regarding the end clients can be limited by third party distributors and nominee structures. In the case of retail funds using third party distributors, fund managers do not have access to the information necessary for modelling investor behavior, e.g. transactional history or whether the investors are on a tax incentivized or pension savings account. In this respect, we recommend that ESMA and national supervisors explore potential steps to improve data accessibility and granularity with a focus on the data needed by asset managers for the purposes of LST.

Q19 What are your views on ESMA's Guideline that aggregated LST should be undertaken where deemed appropriate by the manager?

In our view, an aggregate LST as proposed by ESMA would be of limited use and should be removed from the guidelines. Funds are usually set up as separate legal entities and are managed differently, holding different positions with various time horizons and using various strategies. Liquidity events are

[8] IOSCO, *Recommendations for Liquidity Risk Management for CIS*, (February, 2018) https://www.iosco.org/library/pubdocs/pdf/IOSCOPD590.pdf

generally idiosyncratic to a specific fund; it cannot be expected that redemption in one fund will automatically result in redemption in another fund with the same positions.

A top down approach that considers broad market conditions could provide useful information.

SIFMA AMG sincerely appreciates your consideration of our response and stands ready to provide any additional information or assistance that ESMA might find useful. Please do not hesitate to contact either Timothy Cameron at 202-962-7447 or tcameron@sifma.org or Lindsey Keljo at 202-962-7312 or lkeljo@sifma.org with any questions.

Sincerely,

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