CENTER FOR CAPITAL MARKETS
COMPETITIVENESS

TOM QUAADMAN
EXECUTIVE VICE PRESIDENT

1615 H STREET, NW
WASHINGTON, DC 20062-2000
(202) 463-5540
tquaadman@uschamber.com

September 18, 2017

Mr. Shane Worner
General Secretariat
International Organization of Securities Commissions (IOSCO)
Calle Oquendo 12
28006 Madrid, Spain

Re: Comment on CIS Liquidity Risk Management Recommendations

Dear Mr. Worner:

The U.S. Chamber of Commerce created the Center for Capital Markets Competitiveness (CCMC) to promote a modern and effective regulatory structure for capital markets to fully function in a 21st century economy.[1] We appreciate the opportunity to comment on the ***Consultation on CIS Liquidity Risk Management Recommendations***, published by the International Organization of Securities Commissions (IOSCO) on July 6, 2017.[2] The underlying proposals are responsive to certain recommendations issued by the Financial Stability Board (FSB) on January 12, 2017, to address potential liquidity mismatch between fund investments and redemption terms and conditions for open-ended fund units.[3]

This comment letter continues CCMC's longstanding engagement with FSB, IOSCO, the U.S. Securities and Exchange Commission (SEC), and the U.S. Financial Stability Oversight Council (FSOC) with respect to the regulation of asset managers

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[1] The U.S. Chamber of Commerce is the world's largest business federation, and represents the interests of more than three million businesses and organizations of every size, sector, and region.
[2] International Organization of Securities Commissions, Consultation on CIS Liquidity Risk Management Recommendations (July 6, 2017), available at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD573.pdf [hereinafter 2017 IOSCO Recommendations].
[3] Financial Stability Board, Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities (Jan. 12, 2017), *available at* http://www.fsb.org/wp-content/uploads/FSB-Policy-Recommendations-on-Asset-Management-Structural-Vulnerabilities.pdf [hereinafter 2017 FSB Recommendations].

and asset management vehicles.[4] Specifically, CCMC strongly opposed FSB's and IOSCO's initial proposals to identify non-bank, non-insurer financial entities as global systemically important financial institutions (NBNI G-SIFIs). We appreciate the decision to focus on activities and characteristics that may give rise to systemic risk concerns. We further appreciate that the substantive experts on securities markets – IOSCO and its constituent regulatory authorities – have taken the lead role in the development and implementation of policy recommendations.

However, CCMC believes that global regulatory initiatives need to be considered in light of their potential impact on capital markets and the economic growth they facilitate, and should be sufficiently flexible to take into account global developments as well as jurisdiction-specific reforms, characteristics, and circumstances. While systemic risks should be appropriately monitored and managed, actions to pursue this objective should not be unduly detrimental to the functioning of capital markets and global economic growth. Consequently, we strongly believe that IOSCO and FSB should assess and consider the impacts of their proposals on the functioning of global capital markets, and ensure a balanced approach that does not limit investors' choices or their opportunities for long-term returns.[5] In this light, we remain concerned by the proposed liquidity risk management recommendations. Specifically:

1. Any policy recommendations with respect to liquidity risk management should be backed by methodologically rigorous studies, substantive evidence that liquidity risk in one or more collective investment funds implicates global systemic risk, and a cumulative impact assessment of reforms to the financial services sector to date;

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[4] *See* Letter from CCMC to FSB (Sept. 21, 2016), *available at* http://www.fsb.org/wp-content/uploads/US-Chamber-of-Commerce.pdf; Letter from U.S. Chamber of Commerce Global Risk and Governance Initiative to FSB and IOSCO (May 22, 2015), *available at* http://www.fsb.org/wp-content/uploads/U.S.-Chamber-of-Commerce-Global-Risk-and-Governance-Initiative.pdf; Letter from CCMC to FSOC (Mar. 24, 2015), *available at* https://www.regulations.gov/document?D=FSOC-2014-0001-0014; Letter from U.S. Chamber of Commerce Global Risk and Governance Initiative to FSB and IOSCO (April 7, 2014), *available at* http://www.fsb.org/wp-content/uploads/r_140423ar.pdf; Letter from CCMC to SEC (Oct. 30, 2013), *available at* https://www.sec.gov/comments/am-1/am1-3.pdf.

[5] Consistent with this belief, CCMC strongly endorses certain "Core Principles" for financial regulation set forth in a recent U.S. Presidential Executive Order. *See* Exec. Order 13,772, 82 Fed. Reg. 9,965 (Feb. 8, 2017) (core principles of financial regulation relevant to the liquidity risk recommendations include "(a) empower Americans to make independent financial decisions and informed choices in the marketplace, save for retirement, and build individual wealth . . . (c) foster economic growth and vibrant financial markets through more rigorous regulatory impact analysis that addresses systemic risk and market failures, such as moral hazard and information asymmetry; (f) make regulation efficient, effective, and appropriately tailored.").

2. Asset managers and funds are not banks, and this should be fully recognized when global regulators consider creating new rules and regulatory expectations for the asset management sector, which is already heavily regulated and has not been empirically shown to threaten global financial stability; and

3. Policy recommendations should be appropriately scoped and not overly prescriptive. IOSCO should respect and preserve national regulators' flexibility, with appropriate deference to jurisdictions with well-established asset management regulatory regimes.

These concerns are addressed in greater detail below.

Discussion

I. Need for Additional Study and Cumulative Impact Assessment

If implemented, the proposed liquidity recommendations will not occur in a vacuum. The consultation is the latest in a series of financial regulatory initiatives that could discourage investment in collective funds, disadvantage individual investors saving for long-term goals such as retirement, and ultimately impair the flow of capital available to the businesses that support global economic growth and job creation. As such, CCMC believes that a comprehensive review by IOSCO would be helpful in understanding the cumulative impact – both positive and negative – of these initiatives on non-financial businesses and capital markets.

Furthermore, the recommendations in this consultation may duplicate or overlap with other regulatory initiatives. These initiatives include a series of regulations recently finalized or proposed by the U.S. Securities and Exchange Commission ("SEC") on liquidity risk management and the use of derivatives by investment companies, as well as money market fund reforms in the U.S. and E.U. that harm the ability of non-financial businesses to access the short-term commercial paper markets and manage cash.

We strongly urge IOSCO to examine the cumulative impact of all of these policies on market liquidity before establishing new liquidity standards for investment funds. Several other financial sector reforms being implemented worldwide, such as the liquidity coverage ratio and the net stable funding ratio, have created strong demand for liquid assets, which ultimately remain on the balance sheets of financial

services companies to comply with these requirements. As a result of these reforms, we are starting to witness an inability of corporate treasurers and government finance officers to raise short-term capital and manage cash in ways that were once available to them.[6] It is critically important that any new liquidity recommendations be evaluated in the broader context of global financial services regulatory reform efforts to date. The combination of these initiatives could contribute to an underperforming financial sector, create barriers to capital formation, and have unintended ramifications throughout the rest of the global economy. The inability of businesses to engage in normal capital formation activities, efficient cash management, and effective risk management will raise costs and create inefficiencies adversely impacting economic growth.

Therefore, we believe that IOSCO should focus its efforts on completing a comprehensive impact study that determines:

(1) How all of these initiatives will interact and work together;

(2) the impacts of these initiatives upon different types of capital markets participants and the broader economy, including whether potential policy responses would do more good than harm; and

(3) use modeling techniques to examine the interplay of these new regulatory structures, identify faults, and shape comprehensive fixes.

CCMC believes that no new policy standards for asset managers or asset management vehicles – or for other capital markets participants – should be established without this comprehensive impact study. CCMC welcomes IOSCO's expertise and perspective in this review.

II. Fundamental Differences between Banking and Asset Management

More fundamentally, we would like to continue stressing the distinction between banking organizations and asset managers and funds. Asset managers act as agents for their clients. They typically have small balance sheets that are systemically

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[6] *See, e.g.,* U.S. Chamber of Commerce Survey of Corporate Financial Professionals (June 2016), available at https://www.uschamber.com/sites/default/files/documents/files/financing_growth_report_16_june_16.pdf. *See also* Kirsten Grind, James Sterngold, and Juliet Chung, *Banks Urge Clients to Take Cash Elsewhere*, WALL STREET JOURNAL, Dec. 7, 2014, http://www.wsj.com/article_email/banks-urge-big-customers-to-take-cash-elsewhere-or-be-slapped-with-fees-1418003852-lMyQjAxMTA2MjI1MzcyNjMzWj.

immaterial. Most managers do not employ significant leverage for their own accounts or in the funds and accounts that they manage for their clients. They are not primary creators of risk and do not threaten the stability of the global financial system; rather, they enhance it.

The same is true of collective investment funds. They primarily serve as a low-cost means for investors to access financial assets and professional management, save for long-term goals like retirement, diversify risk, and convert equity investments into cost-effective stable funding for the real economy. They enhance financial stability and economic growth by channeling savings into long-term investments financed by equity. Given all of these qualities, they are natural holders of risky financial assets and have a stabilizing effect on financial markets, as evident during recent periods of stress and heightened volatility.[7] In particular, we note that concerns of contagion as a result of a U.S. registered fund's distress or improbable disorderly failure are misplaced and have not materialized. Such funds do not cause systemic risk. On the contrary, in several respects they act to reduce systemic risk. The FSB's and IOSCO's First Consultation agreed, and stated that:

> [F]rom a purely systemic perspective, funds contain a specific "shock absorber" feature that differentiates them from banks. In particular, fund investors absorb the negative effects that might be caused by the distress or even the default of a fund, thereby mitigating the eventual contagion effects in the broader financial system.[8]

Moreover, U.S. registered funds are fundamentally different from financial institutions that operate through the use of leveraged capital where depositors and creditors rely on the institution's capital cushion to ensure payment of their claims. In

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[7] *See, e.g.*, Matthew Richardson, Prof. of Applied Econ., NYU Stern Sch. of Bus., Asset Management and Systemic Risk: A Framework for Analysis, at 16 ("[g]iven their limited levels of leverage, relatively high degree of transparency, high degree of substitutability, and the pass-through nature of any gains and losses suffered on investments, it seems to me that mutual funds are a natural holder of risk securities in terms of minimizing systemic risk.") (Mar. 19, 2015) (on file with the Fin. Stability Oversight Council, Docket No. FSOC 2014-0001, *available at* https://www.regulations.gov/document?D=FSOC-2014-0001-0033); see also, Letter from Paul Schott Stevens, President & CEO, Investment Company Institute to the Fin. Stability Oversight Council, at 28 ("Portfolio management of stock, bond, hybrid and other funds can provide natural stabilizers for their respective markets, with these funds buying some undervalued securities during a downturn and selling some overvalued securities in a bull market. For many kinds of funds, the investment objectives, policies, and strategies described in the funds' prospectuses may dictate this outcome. Hybrid funds, target risk funds and target date funds all may need to sell securities that have increased in value and buy securities that have fallen in value in order to keep their portfolios in balance.") (Mar. 25, 2015), *available at* http://www.ici.org/pdf/15_ici_fsoc_ltr.pdf.

[8] FSB-IOSCO, Consultative Document, Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions (Jan. 8, 2014) at 1 (the "First Consultation").

sharp contrast, in U.S. registered funds, the shareholders accept the gains and losses to which their investment is exposed, assets are marked to market regularly, and any losses are not absorbed by the asset manager.

Finally, U.S. registered funds are designed and regulated in a way that naturally reduces the potential for systemic risk. Such funds are required to register with the SEC and comply with a comprehensive regulatory regime under the Investment Company Act of 1940 (the 1940 Act). For 75 years, the 1940 Act has enabled investors to access a transparent investment vehicle that, to our knowledge, has never had a significant, adverse impact on financial stability. The reason for this success is that the 1940 Act contains many explicit requirements and limitations, and the SEC has promulgated rules that mitigate risk associated with U.S. registered funds, including:

- Maintaining a portfolio consisting of 85% liquid assets;[9]
- prohibiting the issuance of senior securities by open-end funds;[10]
- daily calculation of NAV and forward pricing;[11]
- maintaining 300% asset coverage for borrowings;[12]
- segregating, earmarking or offsetting assets equal to 100% of any obligation to a counterparty created through the use of derivatives;[13]
- limiting a fund's exposure to its counterparties through collateral control requirements and the use of qualified custodians;[14]
- limiting a fund's investment concentration in a single industry to 25% (unless otherwise disclosed in the fund's prospectus) of the fund's holdings;[15] and

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[9] *See* Revisions of Guidelines to Form N-1A, Investment Company Act Release No. 18612 (Mar. 12, 1992).
[10] *See* 1940 Act § 18.
[11] *See* Rule 22c-1under the 1940 Act.
[12] *Id.*
[13] *See, e.g.*, Securities Trading Practices of Registered Investment Companies, Investment Company Act Release No. 10666 (Apr. 18, 1979), 44 Fed. Reg. 25128 (Apr. 27, 1979).
[14] *See* 1940 Act § 17(f) and rules thereunder.

- limiting a fund's investment in any one financial firm to 5%.[16]

These significant differences strongly counsel against rigidly applying bank-like standards to the asset management industry, which is already heavily regulated, and for further review by IOSCO on whether asset management products or activities actually pose risks that are not already mitigated and, if so, what tools are appropriate to mitigate any such potential risks.

III. Comments on Specific Liquidity Risk Management Recommendations

The proposed recommendations substantially revise and add to existing recommendations contained in IOSCO's 2013 report, *Principles of Liquidity Risk Management for Collective Investment Schemes*. CCMC is concerned that the proposed revisions and additions do not provide sufficient discretion to either fund managers or regulatory authorities with respect to implementation. The text of the recommendations should be revised to clarify that responsible entities and national regulators should implement each recommendation with careful attention to the unique circumstances and characteristics of their respective jurisdictions. Furthermore, the recommendations fail to acknowledge significant variance in liquidity risk among different types of funds. This failure renders many of the detailed recommendations grossly over-prescriptive.

Additional specific concerns are addressed below:

A. Assessment of Liquidity Risk

Proposed Recommendation 4, responsive to FSB Recommendation 3, sets forth expectations for liquidity risk management throughout the entire product life cycle, starting at the design phase and continuing on an ongoing basis.[17] CCMC generally supports Recommendation 4. It is axiomatic that subscription and redemption terms should be aligned with a fund's investment strategy and underlying assets. Furthermore, initial and on-going assessments can positively inform a fund's overall liquidity risk management strategy. However, we strongly oppose the suggestion that a documented assessment of liquidity risks "should be subject to an

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[15] *See id.* § 8(b) (1) (E), see also 76 Fed. Reg. 55,237, 55,254 (Sept. 7, 2011).
[16] *See id.* § 12(e)(2)
[17] 2017 IOSCO Recommendations at 9-11.

internal approval process at a senior management and/or board level."[18] Regulatory mandates for board or senior-most management involvement in granular, fund-level details and decisions are intrinsically ill-founded, and detract from these entities' ability to execute their core risk management responsibilities.

B. Disclosure

Proposed Recommendation 7, responsive to FSB Recommendation 2, sets forth expectations for the effective disclosure of a fund's liquidity risks and liquidity risk management processes.[19] CCMC agrees that disclosure is among the most effective and beneficial tools, one that allows investors to determine "whether their liquidity risk appetite matches the liquidity risk profile" of a fund. Disclosure, on top of additional internal risk management structures and procedures, ensures that the liquidity profile of mutual fund is both understood by investors and well-managed by fund advisers.

However, we have two concerns with respect to the consultation's disclosure recommendations. First, disclosure should be limited to factual assessments of liquidity risks. Liquidity risk disclosures based on projection or speculation are of limited value and may mislead investors. Second, disclosure of liquidity management tools and processes should be limited to what tools may be used, and a general description of the processes through which they would be employed. Excessive specificity in description of the timing, circumstances, and processes under which a tool may be used unacceptably limits managers' discretion and may, in fact, exacerbate systemic risk concerns.

C. Liquidity Management Tools

Proposed Recommendations 4, 16, and 17 contemplate several extraordinary "additional liquidity management tools," including suspension of redemptions, gates, and withdrawal limits. These are all highly disruptive measures which could adversely impact the activities and business model of the asset management industry as well as overall investment in financial assets by fund investors. Consistent with our belief that policy recommendations be grounded in evidence and a well-demonstrated need, CCMC urges IOSCO to undertake additional studies of these additional liquidity tools. Specifically, IOSCO should consider whether its other liquidity risk management recommendations obviate the need for disclosure requirements and

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[18] *Id.* at 10.
[19] *Id.* at 11-12.

contingency planning with respect to additional tools, and whether their formal incorporation into asset management regulatory regimes may have unintended, negative consequences within the industry.

If formal policy recommendations with respect to additional liquidity tools are warranted, we stress the need for flexibility, both at the national level and at the individual fund level. Each fund manager should have discretion in using these extraordinary tools rather than facing a "one-size-fits-all" approach applied uniformly to all fund managers.

D. Stress Testing

Proposed Recommendation 14, responsive to FSB Recommendation 6, concerns the conduct of fund-level stress tests "in line with regulatory guidance."[20] We begin with the observation that FSB Recommendation 6 states that stress testing at the level of individual open-ended funds is necessary "to support liquidity risk management *to mitigate financial stability risk*."[21] Such an assertion renders it incumbent on FSB and IOSCO to positively demonstrate that liquidity risk in open-ended funds does, in fact, generate significant risks to financial stability that stress testing would help mitigate. Absent such a demonstration, we cannot conclude that stress-testing pursuant to regulatory guidance is warranted.

We offer several additional points of caution with respect to stress-testing. CCMC believes that, depending on data availability and methodological rigor, stress-testing may have value as part of the responsible entity's broader liquidity risk management strategy. However, it is critical to recognize the inherent limitations on stress tests' predictive value, particularly with respect to the behavior of market participants outside the fund. Furthermore, conclusions drawn from stress tests should never be substituted for the professional judgment of the portfolio manager.

Conclusion

CCMC greatly appreciates the evolution of IOSCO's and FSB's efforts to monitor and address potential risks in asset management. However, we remain concerned that the proposed recommendations are overly prescriptive, are not appropriately tailored to account for individual jurisdictions' characteristics and circumstances, and address risks that are insufficiently well-demonstrated. We believe

[20] 2017 IOSCO Recommendations at 14.
[21] 2017 FSB Recommendations at 20.

IOSCO must adopt a balanced approach in its proposed measures on liquidity, to avoid and minimize any potential impacts on the ability of businesses of all sizes to access needed financial services. Moreover, it is of paramount importance to ensure that these forthcoming standards do not hamper the asset management sector's ability to continue to invest in their portfolio companies.

Sincerely,

Tom Quaadman