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European Fund and Asset Management Association

EFAMA RESPONSE TO THE ESMA CONSULTATION PAPER ON THE GUIDELINES ON LIQUIDITY STRESS TESTING IN UCITS AND AIFs

GENERAL REMARKS

EFAMA is the voice of the European investment management industry, representing 28 member associations, 62 corporate members and 24 associate members. At end 2018, total net assets of European investment funds reached EUR 15.2 trillion. These assets were managed by almost 62,000 investment funds, of which more than 33,000 were UCITS (Undertakings for Collective Investments in Transferable Securities) funds, with the remaining funds composed of AIFs (Alternative Investment Funds).

Before responding to the questions of this consultation we would like to present the general views of the European asset management industry regarding ESMA's work on the proposed Guidelines on Liquidity Stress Testing (LST) in UCITS and AIFs, as driven by an increased regulatory focus on the potential risk for 'liquidity mismatch' in investment funds.

As presented in the 2019 AMIC/EFAMA report on LST in investment funds[1], LST is an important risk management tool allowing the fund manager to assess the impact of different market stresses at the portfolio level. Moreover, stress testing has long been standard practice in the fund industry and has been strictly regulated by European and national laws for many years and closely supervised by relevant national competent authorities (NCAs). As implicitly foreseen in the UCITS Directive and explicitly required in the AIFMD, managers of UCITS or AIFs have to perform periodic liquidity stress tests. This regulatory setup has consistently proven efficient and robust, including during challenging market events, such as the euro crisis and post-Brexit referendum.

At the same time, it should be acknowledged that managers cannot use stress testing to mitigate against all financial crises. LST is an important analytical input/measure in the overall risk management process in investment funds and allows the fund manager to assess the impact of different stresses at the fund level. However, whilst LST is helpful as part of the risk management process, the results of hypothetical liquidity stress tests should not and do not result in a mechanistic response; rather stress tests are used as information points to highlight potential problems and possible opportunities for risk reduction. That said, the binary nature of market liquidity means that in extreme market events liquidity shocks usually occur

[1] http://www.efama.org/Publications/Public/AMIC-EFAMA%20joint%20paper%20on%20liquidity%20stress%20tests%20in%20investment%20funds%20January%202019.pdf

quickly and cannot easily be predicted by any model. With this in mind, stress tests cannot be a standalone tool to be relied upon as a way of predicting future liquidity crises.

It is also critical to stress that whilst fund managers provide liquidity as part of their fiduciary role in buying and selling investments for individual funds and ensuring they can meet investor redemptions' requests according to the terms of the fund, managers do not exist to make markets or to supply the financial system with liquidity. In their efforts to carry out their fiduciary duties, managers are subject to the dynamic and evolving nature of market liquidity in the same way as other market participants.

EFAMA wishes to underline that apart from the supervisory convergence in relation to the undertaking of LST, it is essential that regulators provide managers a wide array of appropriate tools to deal with liquidity crises when they arise. In this context, it is important for ESMA to encourage NCAs to ensure consistent availability of different types of liquidity management tools (LMTs) across jurisdictions and to extend the existing operational and legal LMTs available to investment funds by taking into consideration existing tools in a number of jurisdictions, such as gates or swing pricing (presented in further details in the AMIC/EFAMA report on Managing fund liquidity risk in Europe[2]). This would be the optimal way to promote a cutting-edge EU approach on liquidity risk management, allow for a level playing field and better enable asset managers to meet their fiduciary duties vis-à-vis the investors.

Concerning the Guidelines proposed by ESMA, EFAMA welcomes the overall objective to suggest principle-based Guidelines, as such an approach can ensure that managers exercise their best judgements based on evolving market dynamics. In our view, what is key for the implementation of the liquidity risk management, including the operation of LST, is the necessary flexibility of how governance is implemented and how the oversight set-up is decided upon. Such flexibility will ensure that the use and selection of stress tests is as relevant as possible to individual funds' strategies. What is also important is to introduce the proportionality to decide the extent and frequency of LST.

In addition, an approach that gives the possibility for a differentiated LST and avoids any overly detailed regulatory approaches prescribing a priori the governance and oversight of LST, is key for avoiding potential systemic risks. Prescriptive rules and scenarios could lead to herding behaviour in the industry, which could contribute to increasing systemic risk in the system.

In this context, we are concerned that part of the Guidelines and in particular of the explanatory statements are taking a more prescriptive approach, which as we will highlight in our responses to the consultation's questions is not appropriate We understand the challenge in striking the right balance between a principles-based approach and an appropriate standardised framework. However, we believe this can be achieved if the key principles of proportionality and flexibility are adopted leading to a framework that recognises the necessity of tailoring LST practices to the nature, scale and complexity of the fund.

[2] https://www.efama.org/Publications/EFAMA_AMIC_Report_Managing_Fund_Liquidity_Risk_Europe.pdf

In relation to the scope of the Guidelines, we agree with covering both AIFs and UCITS – ETFs included – but we believe MMFs should be exempted, mainly as they are already covered by a specific regulatory framework, which is more detailed than the present set of Guidelines.

Our final general remark relates to the availability and access to data regarding the investor basis and the investor behavior. From a redemption risk perspective, availability of and access to that data remains the main challenge.

For many retail funds, investor transactions are incorporated into omnibus trades provided to fund managers by fund distributors who sell products issued by a number of asset managers. Thus, asset managers with retail funds distributed by third parties do not necessarily have access to the detailed transactional history needed to fully study investor redemption behaviours across investor segments within individual funds. The key overall objective remains for both market participants and regulators to be able to get the complete picture of the distribution of funds' liabilities. The access to such additional data could aim at highlighting the set of useful information points that can improve the stress tests models through better profiling, where feasible, of certain underlying investor types.

It is, therefore, important to take due consideration of how lack or scarcity of such data are important constraints for asset managers and result in significant additional time and cost. In this respect, it would be beneficial that asset managers would be supported in obtaining more information on funds' investor base from distributors. Due consideration should be also given to the importance of the availability of comprehensive and good quality trading and other market liquidity data through a global aggregation of consolidated tapes for regulated markets as well as OTC instruments, such as bonds and derivative. Without these, liquidity quantification (including stress testing) is somewhat limited.

RESPONSES TO THE QUESTIONS OF THE CONSULTATION

Q1 What additional costs and benefits would compliance with the proposed Guidelines bring to the stakeholder(s) you represent? Please provide quantitative figures, where available.

Regarding additional costs driven from compliance with the proposed Guidelines, these would be related to the building of additional systems and the scarcity of market data, in particular for some asset classes. Also, introducing certain ad hoc or bespoke per fund stress tests as mandatory for all funds and suggesting changes as to the frequency or the validation of LST will have an important impact on the costs and procedures (see our comments in relation to reverse stress tests, the validation and the frequency of LST in the following responses). The more granular the approach taken by the Guidelines will be, the more the associated costs will increase. It is, however, difficult to provide concrete figures concerning additional costs prior to the implementation of the Guidelines.

We consider, therefore, important that a sufficient implementation period is foreseen, of no less than 24 months, so that the industry has the time to properly implement the Guidelines, assess the associated costs and efficiently deal with them. In addition, it would also be useful that ESMA provides quantitative measures of the costs and benefits of the suggested Guidelines that would also help with asset managers' analysis on costs and benefits.

Also, we consider that LST is an important analytical input/ measure in the overall risk management process, therefore it should not be looked in isolation, but as part of a robust liquidity risk management function. Therefore, we believe that ESMA and national authorities should be focusing their efforts on minimizing operational impediments and facilitating asset managers' liquidity management tasks by ensuring there is a broad availability of risk management tools in their disposal.

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?

EFAMA agrees with the Guidelines applying both for UCITS and AIFs, as long as the approach taken remains high-level-principles-based and allows for the necessary flexibility of how the selection of stress tests remains the most relevant issue. In this regard, we strongly agree that the Guidelines should be adapted to the nature, scale and complexity of the fund. It is also important to introduce a proportionate approach for different types of fuds, for instance UCITS which are legally limited to liquid assets in their investment, therefore frequency and granularity of LST should be adapted to their risk profile.

In the case of ETFs, we agree with their inclusion in the scope of the suggested Guidelines. However, the specificities of ETF structures (including the Authorised Participants' and other liquidity providers' roles) should be fully acknowledged and taken into consideration. Please refer to our answer to Question 13 for more details.

We have, however, important reservations with the inclusion of MMFs in the scope of these Guidelines and some additional points in relation to closed-ended AIFs.

Regarding MMFs, the existing regulatory framework (MMFR) is quite specific regarding stress tests that need to be performed[3]. Each MMF is required to have in place sound stress testing processes that identify possible events or future changes in economic conditions which could have unfavourable effects on the MMF. The MMF or the manager of an MMF shall assess the possible impact that those events or changes could have on the MMF and regularly conduct stress testing for different possible scenarios. These are defined in detail in the MMFR, as well as in the ESMA Guidelines that established common reference parameters of the stress tests scenarios to be included in the stress tests that managers of MMFs are required to conduct[4]. These parameters include daily and weekly liquidity ratios, internal credit quality assessment, KYC policy and other aiming at ensuring appropriate liquidity management. Given the existing

[3] Regulation (EU) 2017/1131 of the European Parliament and of the Council of 14 June 2017 on money market funds, article 28

[4] In this regard, ESMA published the first set of these Guidelines on 21 March 2018, https://www.esma.europa.eu/sites/default/files/library/esma34-49-115_mmf_guidelines_on_stress_tests.pdf. These Guidelines will be updated at least every year, taking into account the latest market developments.

prescriptive framework for MMFs' stress tests, which is also acknowledged by ESMA in the present consultation paper, we consider the additional layer of high-level Guidelines would bring no added value, while to the contrary it can cause important operational impediments and regulatory uncertainty. We take note of ESMA's clarification that MMFR rules related to stress tests should prevail these general Guidelines, in case of conflict, we remain however very skeptical as to the practical implications of applying two set of rules for MMFs. Therefore, we do not support the inclusion of MMFs in the scope of these Guidelines.

In the case of closed-ended AIFs, we consider the implementation of LST would be more difficult due to the idiosyncratic nature of their liabilities. Taking into consideration the different types of liquidity risk in a portfolio, it is important to acknowledge that redemption risk is minimised in the case of closed-ended funds, given there are no on demand redemptions, making thus LST performed on the ability to meet redemptions irrelevant. The main risks in closed-ended funds relate to the use of leverage, therefore for leveraged closed-ended funds, especially with portfolio liquidity, LST can be of value with respect to assessing the ability of the fund to meet margin calls or provide collateral. At the same time, such considerations around liquidity and leverage should be addressed as part of the counterparty exposure procedures an AIFM has in place as part of its risk management process.

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?

Concerning the scope of the Guidelines please see our remarks to the previous question.

On the additional clarity, in relation to the 'nature, scale and complexity' of a fund and as stated in our general remarks, EFAMA is supportive of a principles-based approach allowing the appropriate flexibility of how liquidity risk management is implemented based on evolving market dynamics and the individual funds' strategies. We would, therefore, agree with the general statement on adapting the Guidelines to the 'nature, scale and complexity' of a fund and would not be in favour of further details or clarifications that would end up in a prescriptive, granular approach.

Based on that principles-based approach, we would also consider it important to allow asset managers to tailor LST to their funds based on their liquidity profile, and, if deemed appropriate, exclude certain funds from LST, where the nature of the portfolio and investor base means that liquidity risk is structurally reduced or in cases where normal operations have been suspended. Managers should be given the flexibility to consider criteria to exclude funds which are relatively more liquid or funds with relatively stable and low liability profiles from detailed LST analysis. The same proportional approach could also apply to the frequency required, as frequency should be appropriate to the strategy of the fund.

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?

Liquidity monitoring/management is typically complex and with high requirements on data, making sufficient time to implement changes necessary. As mentioned in our response to Question 1, we consider important that a sufficient implementation period is foreseen, of no less than 24 months, so that the industry has the time to properly operationalize the requirements of the Guidelines, assess the associated costs and efficiently deal with them.

Q5 Do you agree with the proposed approach of setting out a list of Guidelines all funds should follow, and the provision of explanatory considerations to help managers comply with those overarching Guidelines? Do you see merit in including some of the explanatory considerations in the final Guidelines?

EFAMA agrees with the approach of setting out a list of Guidelines that all funds should follow and strongly supports that these Guidelines follow a high-level-principles based approach for reasons already stated in our general remarks and our response to previous questions.

In this regard, we do not consider it appropriate to include the accompanying explanatory considerations in the list of the Guidelines as this will render the Guidelines much more detailed and prescriptive and would contradict the principles-based approach that ESMA intends to take with respect to the Guidelines. Moreover, as presented in our response to the following questions, we believe that in a number of cases the explanatory statements are much more prescriptive and give room to more details than what is foreseen in the Guidelines. We would, therefore, ask for further consistency and a high-level approach ensured also in the case of the explanatory statements. We also see merits in clarifying which explanatory statements fit each Guideline, as this will help asset managers better make use of the comments and clarifications provided in these statements.

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

EFAMA agrees in general with the proposed Guidelines as they are in line with existing industry practices and standard methodologies. However, and despite the statement about a principles-based approach, we consider that some of these Guidelines are more detailed than necessary. This can not only cause important administrative and cost burden, but also lead to procyclicality and financial stability risks, if all market participants follow a same detailed pattern without allowing any natural diversification based on the assessment of market conditions and each fund's strategy and liquidity profile.

A particular comment concerning the introductory remarks prior to the setting of the Guidelines is on paragraph 16 stating that LST should be adequately focused specific to the fund. We agree with this approach allowing the necessary proportionality based on the nature, scale and complexity of the fund, and we would like to stress that this does not imply the need to have one customized scenario for each fund managed by the same asset manager. A targeted scenario can be customized to the specific characteristics of the fund and still be the same for a range of funds run by an asset manager as long as the investment strategies are similar.

Concerning the particular Guidelines, we have a number of remarks and concerns for the following ones:

- <u>Guideline 2:</u> We disagree with the assumption that LST should be documented twice: within a (sepa-rated) LST policy and within the UCITS or AIF risk management policy. Liquidity management is part of the general risk management process. It must be sufficient to document LST in the general risk management policy.

- <u>Guideline 4:</u> Following the principle based approach of the proposed guidelines, it must be clarified that the given frequencies for a more frequent programme of LST are only examples.

- <u>Guideline 5</u>: We do not agree with LST results being part (assisting) in investment decision-making in a mandatory way, particularly in the case of stress tests scenarios with a high unlikely hypothesis. This would unnecessarily constrain the portfolio management-related decisions to the detriment of the portfolio's performance and at the end of the investors' interests. Moreover, setting limits regarding fund liquidity should not be mandatory for funds as the asset manager should be given the discretion to assess the necessity of setting such limits when appropriate for the liquidity profile of the fund and investors' requirements.

  In line with these comments, we suggest the following amendments in Guideline 5:

  'LST should provide outcomes which can be used to:
  a) Help ensure the fund is sufficiently liquid, as required by applicable rules and redemption terms stipulated in fund documentation.
  b) Strengthen the ability of managers to manage fund liquidity in the best interests of investors, including in planning for periods of heightened liquidity risk.
  c) Help identify potential weaknesses of an investment strategy ***~~, and assist in investment decision making.~~***
  d) Assist risk management monitoring ***~~and decision-making~~****, including,* ***where appropriate,*** *relevant* ***~~limits~~ threshold****s regarding fund liquidity. This may include ensuring the results of LST can be measured through a comparable metric, such as a key risk indicator.'*

- <u>Guideline 7</u>: We question the added value of taking only gross redemptions into account, as we consider that net values are relevant. Also, bearing in mind data limitations, gross redemptions can be considered on an optional basis in the context of investor concentrations and possible large redemptions. We would therefore suggest to include in this Guideline reference to "gross ***and/or net*** redemptions".

- <u>Guideline 8</u>: The suggestion should be for "hypothetical ***<u>and/or</u>*** historical scenarios, ***<u>as applicable</u>***" given that historical scenarios may not be relevant for all funds.

Moreover, we disagree with reverse stress testing applying on a mandatory basis for all funds. Currently, reverse stress testing is employed by some managers to assess the "burn rate" of a fund. This calculates how long an open-ended fund can sustain itself with its cash and liquid assets before it experiences a problem. However, reverse stress testing requires lots of efforts of conceptualization and implementation, as it consists in finding the scenarios that cause the fund to fail.

Therefore, it is an optional tool that is bespoke - tailored at individual fund level – making the process very manual and difficult to automate for the wide range of funds. Due to the important amount of work consisting in looking for all possible scenarios leading to each fund's collapse and then filtering out the ones plausible, it is highly disproportionate to require all funds to perform reverse stress testing (high costs and additional man-power and not certain benefit depending on each fund). It should also be kept in mind that contrary to standard stress tests, where the severe scenarios defined to test a fund's liquidity are meant to be plausible, the reverse stress testing can lead to implausible results, as the scenarios that would bring the funds to their point of failure can be too extreme.

Therefore, it should be left to the asset manager's discretion to decide whether there is an added value of performing reverse stress testing to define a contingency plan and manage critical liquidity events or not[5].

- Guideline 10: We consider that the manager- or fund-specific approach is better than the time- and/or cost-related one to determine the effect on fund liquidity. We would, therefore, suggest a broad principle rather than referencing these two approaches, given that ESMA acknowledges in this consultation paper that other approaches may be adopted as appropriate to the fund. Managers should maintain the flexibility to consider the trade-off between limiting liquidation costs and maintaining a fund's risk profile.

  In line with these comments, we suggest the following amendments to Guideline 10 :
  'LST should enable a manager to assess not only ***the possible approach*** ***~~time and/or cost~~*** *to liquidate assets in a portfolio, but also whether such an activity would be permissible given:*
  a) The objectives and investment policy of the fund.
  b) The obligation to manage the fund in the interest of unitholders.
  c) Any applicable obligation to liquidate assets at limited cost.
  d) Any obligation to maintain the risk profile of the fund following liquidation of a portion of its assets.'

  Moreover, suggesting including investment guidelines and investment lines into the risk management would mean incorporating the current external risk management system in the same system as the one for investment guidelines, which is too difficult in terms of the current conditions and risk system support.

[5] We also note that even in the more prescriptive rules of MMFR article 28, as further defined in the ESMA Guidelines (see footnote 2), under paragraph 18 reverse stress testing is seen as a non-mandatory, optional tool ("may also be of benefit").

- Guideline 11: We agree that LST should incorporate scenarios relating to the liabilities of the fund, including redemptions and other types of potential sources of risk, but we would call for a proportionate approach including other types of risk where there is material impact. Therefore, we would suggest the following amendment***: "(where*** ***~~applicable~~ appropriate, e.g. in the case of other types of potential source of risk, based on their material impact)".***

- Guideline 14: We are very much doubting the beneficial outcome of aggregating the stress testing results at the asset class level, investment fund level and/or on investor group/investor level. Given that most funds are set up as separate legal structures, there is no interconnectedness across funds or management structures as they are managed in different ways and for different investor bases. In particular, as separate legal entities, the manager does not have recourse to the assets of one fund to meet the liabilities of another fund. Even if a management company-wide view can be put in place, the decision on the exact set-up for individual funds should remain with the relevant fund manager. It is also important to recall that liquidity (liquidity risks) can only be assessed and managed at the individual fund level, not at the company level. This is because the assets and liabilities of a fund are managed at the fund (asset owner) level.
  Moreover, if there could be an added value of "aggregate" results by asset class level, investment fund level and/or on investor group/investor level for regulators this should notbe based on liquidity indicators. Rather, it could be on the basis of holdings and only when appropriate. Hence, such "exercise" cannot be useful if limited only to asset managers, as investment funds represent only partially the asset investors' side.
  We, therefore, strongly believe there is no benefit to gain from aggregating testing, as in any case this would require to always go back to the individual fund stress tests results to assess risks.

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

EFAMA generally agrees with the explanatory statements regarding LST of fund assets, apart from the following points.

In relation to stressed market conditions, it is referred in paragraph 27 that 'financial markets typically exhibit higher volatility and lower liquidity'. We consider such a statement is not fully accurate as there is observable data showing volumes and liquidity increased for liquid assets (e.g. liquid government bonds) in such periods. Therefore, this statement is not warranted in the explanatory considerations.

In relation to data availability, the relevant Guideline and explanatory statements acknowledge existing limitations and require asset managers to ensure that any assumptions are adequately validated, documented and justified. This requirement, especially in relation to expert estimates, will entail significant additional time and cost, which should be kept in mind when deciding the time needed to implement the Guidelines.

Moreover, in relation to the data scarcity it is also important that asset managers are supported to overcome challenges in obtaining more information on underlying funds' investors from distributors. From a redemption risk perspective, availability of and access to data in relation to the underlying investors and/or possibility to identify the key players in the distribution chain that have an impact on the redemption flows remains challenging. It is also necessary that due consideration is given to the importance of the availability of comprehensive and good quality trading and other market liquidity data for OTC instruments, such as bonds and derivative. Without these, liquidity quantification (including stress testing) is somewhat limited.

On the asset liquidation method, it is not always feasible to reflect how a manager would liquidate assets under normal and stressed conditions. The overarching principle is that any adjustment to the portfolio's composition, including when triggered by redemptions or subscriptions, should result in keeping the risk profile in line with the investment objective of the fund. Portfolio managers should have the flexibility to use professional judgement to decide which approach is considered most appropriate in the market at the time of trading, meaning it is not always feasible to reflect the asset liquidation method a priori. Therefore, what is necessary is a flexible and time-appropriate approach relying upon the expertise of individual fund managers and avoiding processes or assumptions not reflecting the real practical conditions. Asset managers should have access to a full kit of liquidity management tools and a defined process setting out the considerations that should be taken into account when deciding to use any of these tools. The LST needs to reflect the approach the manager takes in a stressed scenario.

Moreover, the fiduciary duty of an asset manager is to manage investors' money in accordance with the agreed investment strategy, appropriate regulations and constraints within fund rules. All things being equal, the treatment of all shareholders of a fund would imply that asset liquidation should ideally take place by selling assets across all liquidity profiles. All this needs to be adapted in reality to account for technical constraints, costs and portfolio rebalancing opportunities. For instance, the differences in asset transaction costs (i.e. liquidation) can also play a role in determining the process of liquidating assets. So, in practice, portfolio managers might use redemptions to steer the outcome towards their model portfolio. Therefore, a 'vertical slice' being in theory the ideal approach, might not be necessary to generate the same risk profile before and after liquidation. Conversely, even if the 'waterfall' approach does not allow for the perfectly equal treatment of investors, there are cases where the investment strategy and the best interests of investors may lead to the 'waterfall approach' being more suitable.

We would also suggest to change the reference to "prospectus" to "prospectus or fund rules", since prospectus are not be the sole document that governs the contractual relationship between fund and investors[6].

Finally, as a general remark, in order to avoid further prescription of the Guidelines, it would be important to add a clarification that the explanatory statements are not part of the rules, but are to be handled as considerations during the implementation of the Guidelines by asset managers. In addition, the choice of wording, e.g. in paragraph 22 a manager 'should' choose the method used / a manager 'should' also be

[6] The contractual relationship between fund and investors, including the definition of redemption ruls, is regulated by national contract law and may be subject to differences among the EU jurisdictions.

aware of the method's limitations, has to be adjusted to reflect that these statements are considerations and not rules.

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

On reverse stress testing please see our response to question 6 and in particular with respect to Guideline 8. EFAMA disagrees with reverse stress testing being mandatory for all funds. **We would therefore suggest introducing the reference 'where appropriate' in Guideline 8, leaving that to the manager's discretion.**

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?

EFAMA does not see merit in providing further considerations for managers in relation to the use of data relevant to asset liquidity. It is for the fund manager to assess the existing available data and adapt its LST to given circumstances based on the high level principles foreseen in the Guidelines.

The only point necessary is for ESMA and national regulators to fully take into account that existing limitations and scarcity of data will mean additional time and costs in implementation.

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?

As stated in our response to Question 7, it is not always feasible to reflect how a manager would liquidate assets under normal and stressed conditions. The overarching principle is that any adjustment to the portfolio's composition, including when triggered by redemptions or subscriptions, should result in keeping the risk profile in line with the investment objective of the fund. Portfolio managers should have the flexibility to use professional judgement to decide which approach is considered most appropriate in the market at the time of trading. Meaning, it is not always feasible to reflect the asset liquidation method a priori.

What is necessary is a flexible and time-appropriate approach relying upon the expertise of individual fund managers and avoiding processes or assumptions not reflecting the real practical conditions. **We would, therefore, suggest changing the wording in para 32 ('(…) ~~always accurately~~ reflect how a manager <u>could</u> liquidate assets during normal ad stressed conditions') in order to allow appropriate modifications in the actual event.**

It is also important to keep in mind that the fiduciary duty of an asset manager is to manage investors' money in accordance with the agreed investment strategy, appropriate regulations and constraints within fund documentation. In addition, all things being equal, the treatment of all shareholders of a fund would imply that asset liquidation should ideally take place by selling assets across all liquidity profiles. All this needs to be adapted in reality to account for technical constraints, costs and portfolio rebalancing opportunities. Therefore, a 'vertical slice' being in theory the ideal approach, might not be necessary to generate the same risk profile before and after liquidation. Conversely, even if the 'waterfall' approach does not allow for the perfectly equal treatment of investors, there are cases where the investment strategy and the best interests of investors may lead to the 'waterfall approach' being more suitable.

For that reason, we would suggest making reference to these two standard approaches in the explanatory statement ('vertical slice' and 'waterfall' approach) that can be used together with considerations to be taken into account when deciding the liquidation method. Asset managers should have access to a full kit of liquidity management tools and have in place a defined process setting out the considerations that should be taken into account when deciding to use any of these tools. The LST needs then to reflect the approach the manager takes in a stressed scenario.

Q11 Do you agree with ESMA's wording regarding 'second round effects'? What is your current practice regarding modelling 'second round effects'?

Although EFAMA is not aware of evidence for 'second round effects' caused by investors' redemptions and this concept is contentious – as acknowledged by ESMA - this hypothesis and the estimated costs are taken into consideration in the risk management process as a whole. However, it would be difficult to incorporate the hypothesis on 'second round effects' in the LST as such, as there are limitations and uncertainties with respect to the behaviour of other market players. Moreover, we consider that it is the individual instruments' liquidity within the overall market liquidity and historical scenarios that should be taken into account.

What is also important is for the manager to have at its disposal a well-diversified toolkit of liquidity instruments, such as gates, to be able to address different types of risks. The existence of this toolkit can therefore contribute to the manager's duty to act in the best interest of investors, as well as to the overall market stability.

Q12 What are your views on the considerations on difficult to model parameters, such as price uncertainty? What is your current practice concerning this issue?

EFAMA agrees with the consideration that there are difficult to model parameters, such as price uncertainty, but considers it would be difficult to include those in the LST. In the case of price uncertainty, incorporating market risk analysis can be used to get an indication of a potential market situation, but individual fund stress testing is not expected to accurately predict the future or the behaviour of other market participants. Therefore, decisions on extraordinary measures need to be assessed and decided at the opportune moment, given that trading as a result of redemptions is preferably done as close as possible to the valuation price. This limits the liquidity risk as a result of asset price volatility or asset price uncertainty.
Still, even with timely trading, there might be certain scenarios in which there is significant price uncertainty. In that case one might want to resort to swing pricing and valuation at transacted price before

restricting redemptions, both being good practices that have been developed in the EU[7]. In this context, difficult to model parameters are factors that can be taken into consideration together with all other relevant factors in the process of selecting the appropriate liquidity tool in each case. This highlights once more the need for asset managers to have access to a well-diversified toolkit for liquidity management.
Therefore, we suggest to avoid a reference to 'second round effects' and focus on how an asset manager could liquidate assets in normal and stressed market conditions.

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?

EFAMA agrees in principle that there are additional considerations to be taken into account for funds invested in less liquid assets.
In the AMIC/EFAMA report of January 2019[8], a concrete reference is made to recent experiences in the area of real estate funds, i.e. the reduced liquidity Germany experienced in the last decade and the lessons learned from UK commercial real estate funds following the Brexit referendum result. In the first case, reduced liquidity led to the implementation of legal gates for open-ended real estate funds. In the case of UK commercial real estate funds and the market turmoil following the Brexit referendum, it appeared that the relevant UK real estate funds were able to manage their potential fund liquidity risk and eventually re-opened the possibility of redemptions after temporary suspensions together with a far greater focus on the quality of investor disclosure as to how these tools will be applied in a stressed situation. It is, however, important to note that in both cases there are highly valuable lessons for commercial real estate funds, but these may not be useful in stress testing other asset classes, such as corporate bond funds.

Concerning ETFs, as already mentioned in our response to Question 2, we agree with their inclusion in the scope of the suggested Guidelines, as ETFs fall in the scope of the UCITS Directive and are treated as UCITS. At the same time, the specificities of ETF structures (including the Authorised Participants' and other liquidity providers' roles) should be fully acknowledged. For instance, it is important for ETF issuers to test the tradability of an ETF's underlying "primary" market already in the pre-launch phase of the product, to determine whether a sufficient degree of liquidity exists to support Authorised Participants' creation/redemption processes. Such considerations are critical also for the ETF to attract sufficient inflows in view of achieving a minimum size beyond which economies of scale are expected to support the commercial success of the ETF post-launch.

It is also essential to recognise the existence of a "secondary" market, where investors in ETFs access liquidity by trading their shares intraday between each other, offering an ETF an additional "layer" of liquidity. In light of their proven resilience to liquidity risks, especially during times of heightened market volatility, we deem that ETFs need no ad hoc or "tailored" Guidelines in this respect.

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[7] There is also the approach of anti-dilution levies, which was introduced as part of the SEC 22e-4 Rule in the US with the purpose to ensure the price redeeming investors receive (or subscribing investors pay), reflects the cost of selling (or purchasing) the underlying assets, rather than the published mid-market price.
[8] See footnote 1

Hence, we strongly support that these high-level-principles based Guidelines applying to all types of funds are the ones applying also to ETFs, with no need for further ETF-specific Guidelines. As long as the overarching principle of a proportionate and flexible approach is maintained, adapting these Guidelines to the specific features of ETFs would be feasible for their asset managers.

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

EFAMA agrees with the considerations regarding LST on items on the liabilities side of a fund's balance sheet and this being an exercise reflecting both normal and stressed market conditions. EFAMA also agrees with the mention that the types of liabilities vary and are different across funds, hence the examples given in para 47 are to be considered as non-exhaustive.

When stress testing the liabilities of a fund, managers will aim to model and stress test the different forms of liabilities such as those derived from financial derivatives investments (e.g. margin) and those arising from redemption flows. Regarding the latter, factors such as investor concentration, and the "stickiness" of investor money and fund performance are normally assessed alongside main historical flows to help form a view of likely future liabilities. Moreover, the general knowledge of the investor concentration of each fund can be important. Scenarios based on the exit of a certain number of top investors can also be very useful as can the ad hoc review of historical account flows to identify trends and the likelihood of any significant single investor redemption. In addition, common practice apart from historical views, is to closely follow larger investors, through direct contact and direct servicing, so that the liabilities' analysis is done with the view of grasping the main trends.

However, when it comes to investor behavioural model/analysis or the granular knowledge on the liability side, managers are faced with important challenges mainly due to lack or scarcity of timely and accurate data. In most cases, the manager's knowledge about the investor's degree of sophistication is limited, especially for retail investors. For many retail funds, investor transactions are incorporated into omnibus trades provided by distributors, who interact with a number of asset managers via the same account. Thus, managers with retail funds distributed by third parties do not necessarily have access to the detailed transactional history needed to fully map investor redemption behaviour across investor segments rather than individual client level data within individual funds. In such cases, a global statistical approach may be used, potentially split by type of distribution channel. Furthermore, the knowledge and experiences in financial markets will usually depend on the type of investors. This applies in particular in the cases of funds with professional investors only[9].

[9] The managers of those funds have to fulfil special reporting requirements on the composition of the portfolio vis-à-vis the investors' particular regulatory requirements - such as the Basel framework for banks implemented in Europe under the Capital Requirements Directive or for insurance undertakings under the European Solvency Directive.

For the reasons mentioned above, the incorporation of an analysis based on investor behaviour can become more robust and accurate when asset managers have better access to detailed information related to a fund's ultimate investor base and the transactional history.

In the case of LST on other types of liabilities we question how the examples on securities financing transactions, derivatives and interest/credit payment can be part of liquidity stress testing, as they are part of credit risk. We therefore see merits in limiting this list only to margin calls. In general, it should be stated that any other liability is to be considered only if there is a material impact on the fund's liquidity.

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?

EFAMA agrees with the distinction and considers that any other liability is to be taken into account only if there is a material impact on the fund's liquidity. On our comments concerning the other types of liabilities please see our response to the previous question.

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

As stated in our response to Question 6 and the relevant Guideline 8, as well as to Question 8, EFAMA disagrees with reverse stress testing being mandatory for all funds. Reverse stress tests require lots of efforts of conceptualization and implementation and can lead to implausible results, as the scenarios that would bring the funds to their point of failure can be too extreme.
Due to the important amount of work consisting in looking for all possible scenarios leading to each fund's collapse and then filtering out the ones plausible, it is highly disproportionate to require all funds to perform reverse stress testing.
Therefore, it should be left to the asset manager's discretion to decide whether there is an added value of performing reverse stress testing to define a contingency plan and manage critical liquidity events or not.

Q17 Do you agree with the requirement to incorporate investor behavior 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?

For reasons already mentioned in our response to Question 14, the incorporation of an analysis based on investor behaviour will be more robust and accurate when asset managers have better access to detailed information related to a fund's ultimate investor base and the transactional history. **This should be reflected in the Guidelines,** given that the absence of timely and accurate data is a constraint that asset managers should not be required to justify**.**

Q18 What do you think about ESMA's Guideline stating that managers should combine LST results on both sides of the balance sheet?

EFAMA agrees in principle that there is added value from combining LST results on both sides of the balance sheet, therefore allowing the possibility to draw additional conclusions at the level of the fund and not only on the liabilities' or assets' side only. At the same time, we wish to stress the importance to avoid prescriptive ways for this combination or a preference for a given methodology, given that existing practice does not provide such evidence.
We disagree, however, with the proposal suggested by ESMA in the explanatory statements to compare LST results from more than one fund using this as a 'risk-scoring', because redemption dynamics could be very different for different funds. We think that comparing LST results for more than one fund should only make sense between funds which share similar strategies and profiles.

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

We already mentioned in our response to Question 6 and the relevant Guideline 14 our doubts in respect of the beneficial outcome the aggregation of the stress testing results can have at the asset class level, investment fund level and/or on investor group/investor level. Given that most funds are set up as separate legal structures, there is no interconnectedness across funds or management structure as they are managed in different ways and for different investor bases. At the best case, LST on an aggregated number of funds may be useful when considering families of funds with closely interrelated investment strategies, same exposure and risk profile and managed by the same portfolio managers.

What is important to note is that as separate legal entities the manager does not have recourse to the assets of one fund to meet the liabilities of another fund. Even if a management company-wide view can be put in place, the decision on the exact set-up for individual funds should remain with the relevant fund manager. It is also important to recall that liquidity (liquidity risks) can only be assessed and managed at the individual fund level, not at the company level. This is because the assets and liabilities of a fund are managed at the fund (asset owner) level.

Moreover, if there may be an added value of "aggregate" results by asset class level, investment fund level and/or on investor group/investor level for regulators this shouldn't be based on liquidity indicators. Rather, it could be on the basis of holdings. Hence, such "exercise" cannot be useful if limited only to asset managers, as investment funds represent only partially the asset investors' side. We therefore strongly believe there is no benefit to gain from aggregating testing, as in any case this would require to always go back to the individual fund stress tests results to assess risks.

Q20 What is your experience of performing aggregated LST and how useful are the results?

N/A

Q21 What are your views on ESMA's considerations concerning the use of LST during a fund's lifecycle?

EFAMA agrees that LST should be used at many stages of a fund's lifecycle. We also agree with the approach of Guideline 4, i.e. that LST should be employed at all stages in a fund's lifecycle, where appropriate, as this would mean that the employment of LST would depend upon its possibility to support decisions providing input on the liquidity of the fund. However, we consider that the explanatory considerations, are more prescriptive requiring LST as mandatory for every stage of the fund lifecycle. We would instead suggest a better alignment of the explanatory considerations with the proportionate approach taken in Guideline 4.

In particular, we consider that an assessment of liquidity risks at the time of product development and the fund launch is important, demonstrating the key elements that will enable a fund to remain sufficiently liquid during normal and stressed market conditions. At the same time, as during the product development phase there are none or few data feed on investment behavior, target portfolio size or even investor structure and non-existing specific individual instruments, the application of LST may be of limited value in practice. Instead, the process may rely upon a qualitative estimation of liquidity risks of the fund under normal and stressed conditions and the consideration of available/applicable liquidity tools. Another practice at this stage is to replicate standard terms and values of already existing funds with similar/comparable investment strategy, size and investor base.

Also, at the time of the fund closure, we do not consider that LST is of particular value, as the fund has ceased trading and during the orderly closure the fund's manager may make use of the available liquidity management tools, if necessary and appropriate for the fair treatment of the remaining investors, without the need for LST.

Q22 What is your experience of the use of LST in determining appropriate investments of a fund?

The determination of the appropriate investment derives from the fund's investment objectives and mandate and should not be based on the use of LST. Moreover, the liquidity of an instrument may vary in different periods of time making the relevance of LST for the determination of appropriate investments limited.

It is also important to note that whilst LST is helpful as part of the risk management process, the results of hypothetical liquidity stress tests should not and do not result in a mechanistic response. Stress tests are used as information points to highlight potential problems and possible opportunities for risk reduction. With this in mind, stress tests cannot be a tool to be relied upon to determine appropriate investments of a fund.

Q23 In your view, has ESMA omitted any key uses of LST?

EFAMA considers there is nothing more to be added.

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?

EFAMA agrees with the frequency foreseen in the ESMA Guideline calling for LST at least on an annual basis, as this is in line with the AIFMD. We also agree that it should be the asset manager determining the need for increased frequency of LST based on the characteristics of the fund.

Concerning the additional recommendation in the explanatory statement to undertake LST at least quarterly we believe this is not proportionate for different types of funds, e.g. for UCITS which are required to invest in liquid assets and to not employ substantial leverage and have a very diversified investor base or for closed-ended funds with no or limited redemption opportunities.

For that reason, we would strongly support to delete from the explanatory statements the reference to the Quarterly basis for the frequency of LST and align with Guideline 4 foreseeing LST to be conducted at least annually with more frequent LST employed if required by the characteristics of the fund.

Concerning the factors that may increase the frequency of regular LST, we suggest to remove the example given related to the extensive use of derivatives, as this does not necessarily result into complex investment strategies. We would also suggest to add a reference to "lower risks from liabilities" in the factors which may decrease the frequency of regular LST.

Q25 Should ESMA provide more prescriptive Guidelines on the circumstances which can justify a more/less frequent employment of LST?

The need for more/less frequent LST should be left at the discretion of the fund's manager, therefore no more prescription is necessary in the Guidelines or the explanatory statements.

Q26 Do you agree that LST should be employed outside its scheduled frequency (ad hoc) where justified by an emerging/imminent risk to fund liquidity?

EFAMA agrees with undertaking ad-hoc LST in the case of material risks that require a timely assessment, although we consider it more appropriate to use a more general description on the need to anticipate reasonably foreseeable stressed market conditions. At the same time, it is important to stress that the notion of 'emerging/imminent risk' should not be used, as this is the sole decision of the asset manager.

Overall, undertaking such LST remains a decision to be taken by the fund's manager as is the decision of what measures are appropriate in a stressed situation. Therefore, in case of stressed conditions undertaking LST should be considered only as an option with the managers being able to take whichever measures they consider timely and appropriate. It should be also kept in mind that stress tests are employed in order to test on the basis of scenarios and get meaningful results for the purposes of monitoring the liquidity risk. Whereas, in imminent conditions/situations there is not anymore an issue of a test, rather than a requirement for action.

Q27 What are your views on the governance requirements regarding LST?

EFAMA agrees overall with the governance requirements regarding LST, but has the following requests for further clarification. Firstly, it seems appropriate and in line with UCITS Directive and AIFMD to mention concerning the ownership of the LST policy that the Risk Management is the relevant function. As a second point, in the case of validation and back-testing a more proportionate approach would be preferred. Given the additional cost and complexity in implementing any such validation process and back-testing these are to be used in case of added value.

Q28 Should more information be included in the UCITS RMP and AIF RMP?

EFAMA strongly supports a proportionate approach to be taken when including LST information in the RMP of a UCITS or an AIF, therefore, including information that is relevant. In this respect, we do not consider appropriate to prescribe further information to be included in the UCITS/AIF RMP.

Q29 Do you have any views on how managers which delegate portfolio management can undertake robust LST, independently of the portfolio manager, particularly when the manager does not face the market?

In many cases UCITS management companies and AIFMs would still retain the expertise and the access to the necessary information when delegating portfolio management. Therefore, they have the ability to perform LST and if necessary, challenge the results and decisions of the portfolio manager. In other cases, the responsibility to undertake LST is with the designated entity, but also in these cases an adequate communication channel and interaction should always be in place to allow a clear understanding of the process and that it is based on market conditions and investors' behaviour.

Q30 Do you agree with the proposed Guideline for depositaries on carrying out their duties regarding LST?

EFAMA agrees with the general statement in paragraph 78 that the Guidelines do not require a depositary to replicate the LST undertaken by a manager. We would, however, like to add that the Guidelines do not require a depositary 'to challenge' the LST undertaken by a manager.

Overall, the role of the depositary is limited to ensuring that a LST policy and process is in place. Therefore, such verification of LST by depositaries should not be construed to imply the replication or duplication of LST put in place by the management company. Such exercise would not only be redundant, but more importantly, also not appropriate to the business nature and expertise of depositary institutions.

Q31 In your experience do depositaries review the UCITS RMP and AIF RMP as a matter of course?

It is not a common practice for depositaries to review UCITS RMP and AIF RMP. As part of its due diligence on management companies, the depositary typically ensures that the LST policy, procedure and RMP are in place.
Please see also our remarks to the previous question.

Q32 Do you see merit in ESMA publishing further guidance on the reporting of results of liquidity stress tests? If so, in your view how should ESMA require that results be reported?

Given the high-level-principles-based approach taken in these Guidelines, EFAMA does not see merits in ESMA publishing further detailed guidance on the reporting of LST results.

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Brussels, 22 March 2019