FINANCIAL CONDUCT AUTHORITY

12 Endeavour Square
London
E20 1JN

Tel: +44 (0)20 7066 1000
Fax: +44 (0)20 7066 1099
www.fca.org.uk

04 November 2019

Dear Chair

Effective liquidity management: good practice for Authorised Fund Managers

As an Authorised Fund Manager (AFM), ensuring effective liquidity management in funds is a central responsibility for you, and it remains your responsibility even if you have delegated investment management to another person. Good fund governance ensures the liquidity of your funds' underlying assets is appropriately considered.

However, open-ended funds are not always able to liquidate assets sufficiently quickly to meet increased redemption requests from investors. This issue can be more acute in daily dealing funds, which make up most of the retail market in the UK. Your firm can prevent this leading to harm through suitable portfolio composition, effective fund governance, including by independent directors, understanding your investor base, as applicable, and investors' redemption rights, and using liquidity tools appropriately, particularly in times of market volatility and stress.

What we are doing

On 30 September 2019, we published a policy statement (PS19/24) on illiquid assets and open-ended funds, outlining measures to strengthen the regulatory framework in this area. These included mandating temporary suspension of dealing in certain circumstances, improvements in liquidity management processes for impacted funds and increased disclosure to customers. This policy statement focused on non-UCITS retail schemes (NURS), however firms should recognise that effective liquidity management is an irreducible, core function for all open-ended funds. Although the new rules do not come into force until September 2020, fund managers (and depositaries) may wish to consider whether it would be in investors' interests to adopt some of the measures, such as improved liquidity management, ahead of the coming into force date, where these do not conflict with the rules in force before then.

What we want you to look at

Please consider your obligations on portfolio composition, asset eligibility, and liquidity management. We would also like you to review your liquidity management arrangements against the FCA good practice referred to below.

Portfolio composition

AFMs of UK authorised funds must consider the appropriateness of assets they invest in. See the Collective Investment Schemes (COLL) sourcebook for requirements for asset managers and authorised funds.

- COLL 5.2.7AR outlines the criteria which transferable securities must fulfil to be an eligible asset for a UCITS scheme. These criteria also apply to transferable securities held by NURS (see COLL 5.6.5AR).
- COLL 5.2.3R requires that AFMs should ensure UCITS funds have a prudent spread of risk (see COLL 5.6.3R for NURS). This requirement to consider the spread of risk is in addition to the specific provisions on spread for UCITS in COLL 5.2.11R, such as the requirement that no more than 10 per cent of scheme property should consist of transferable securities issued by any single body.
- Meeting the requirements in COLL 5.2.11R may not, in itself, ensure a prudent spread of risk in a fund.
- AFMs must at all times during a dealing day comply with their obligations to redeem units at the request of qualifying unitholders under COLL 6.2.16R(3).

In particular, AFMs should consider the requirements under COLL 5.2.7AR, including that the liquidity of a transferable security does not compromise their ability to redeem units in the fund. Assessing the liquidity of an asset may require you to consider several factors. This could include considering whether a security is, in practice, sufficiently liquid, even where it is admitted to trading on an eligible market.

Where assets are less liquid, robust valuation practices are vital. Our 2017 review into hard to value assets highlighted the need for firms to have expertise and independence in their valuation process, as well as that firms need to be able to demonstrate meaningful adherence to their valuation policies.

Liquidity management for investment firms: good practice

Firms must have appropriate systems, controls and governance to oversee and manage liquidity risks. Our paper Liquidity management for investment firms: good practice outlines good practice for dealing, and disclosing, overseeing and implementing liquidity tools. Please review your arrangements against this and improve them where necessary, and make sure that you comply with the applicable requirements for liquidity management and valuation under FCA rules and directly applicable European regulation when doing so.

Key features of robust liquidity management include:

- processes to ensure that the fund dealing (subscriptions and redemptions) arrangements are appropriate for the investment strategy of the fund
- regular assessment of liquidity demands
- an ongoing assessment of the liquidity of portfolio positions
- using liquidity buckets for liquidity risk management
- an independent risk function that monitors portfolio bucket exposures regularly and reports breaches to the set limits
- stress testing by fund managers to assess the impact of extreme but plausible scenarios on their funds

These fundamental features are particularly beneficial when combined with a formal policy of liquidity thresholds and triggers that prompt escalation to an appropriate risk committee or action in themselves. Particularly for less liquid funds and funds investing in less liquid assets, we see clear benefits to setting liquidity triggers for considering fund suspension, which are discussed in detail with fund boards and their depositaries.

You should review your practices for liquidity management in authorised funds to ensure they enable you to meet your obligations to investors to have adequate liquidity in the funds you operate to meet their redemption requests.

To help with this review please also see The International Organization of Securities Commissions (IOSCO) recommendations that seek to improve liquidity risk management practices of open-ended collective investment schemes. You should review these recommendations as part of your review of liquidity management and consider the extent to which your own arrangements are in line.

IOSCO 2018 liquidity recommendations

The IOSCO report contains 17 recommendations for entities responsible for managing the liquidity of funds e.g. AFMs to ensure that liquidity is managed to safeguard and protect the interests of investors, including in stressed market conditions. Some of the key recommendations are that the responsible entity should:

- set appropriate liquidity thresholds which are proportionate to the redemption obligations and liabilities of the fund
- ensure that it will have access to, or can effectively estimate, relevant information for liquidity management
- regularly assess the liquidity of the assets held in the portfolio
- have a liquidity risk management process so it can identify an emerging liquidity shortage before it occurs
- incorporate relevant data and factors into its liquidity risk management process to create a robust and holistic view of the possible risks
- conduct ongoing liquidity assessments in different scenarios, which could include fund level stress testing, in line with regulatory guidance

- put in place and periodically test contingency plans to ensure that it can use any applicable liquidity management tools where necessary quickly and in an orderly way

Next steps

We have provided details of good practice for liquidity management in your authorised funds, which are particularly relevant during times of volatility and stress. Please review your firm's practices as soon as practicable to ensure you and your fellow AFM board members are comfortable they are appropriate.

If you have any questions, please contact us on 0300 500 0597 or see our website.

Yours faithfully

Nick Miller

Head of Asset Management Department, FCA