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Fund Liquidity

Still a Global Cause for Concern

Increasingly, regulators globally have become concerned about two aspects of open-ended funds' liquidity. Firstly, that funds do not trade with investors in a manner that reflects the liquidity of their underlying portfolios and secondly, that the underlying portfolios are not as liquid as the regulators would expect them to be.

This has led jurisdictions and international bodies to question the rules that they have, to date, applied.

In this article we look at the current work being undertaken by national and supranational regulators to try and solve the problem of liquidity mis-match in open-ended collective investment schemes.

Finding the right tool for the job

Historically, available liquidity management tools (LMTs) were limited to deferred redemption (where the execution of all, or a proportion, of redemptions are deferred to a later date if the redemptions are greater than a predetermined trigger), limited redemption (where pre-determined caps are placed on an investors ability to redeem units within specified timescales), notice periods, and the last case scenario – suspension.

In recent years, regulators have also been looking at tools originally designed to mitigate the impact of dealing costs, redesignating them as tools that can be employed to manage liquidity.

These 'anti-dilution' tools, such as dual pricing, dilution levies and swing-pricing, have been used for many years to reduce the impact dealing charges have on a fund, ensuring investors leaving or entering a fund bear the resulting costs arising from transactions in the underlying assets.

To date, fund managers have been free to decide when and if dilution adjustments are made. However, regulators have recently looked at imposing anti-dilution tools as a means to manage funds' liquidity.

IOSCO

At a global level, on 20 December 2023, the International Organization of Securities Commissions (IOSCO) published Anti-dilution Liquidity Management Tools – Guidance for Effective Implementation of the Recommendations for Liquidity Risk Management for Collective Investment Schemes (IOSCO Guidance).

The IOSCO Guidance aims to support IOSCO's liquidity risk management (LRM) Recommendations related to the use of anti-dilution LMTs and is a result of its July 2023 consultation.

It covers the design and use of anti-dilution LMTs by open-ended funds; the oversight by fund boards, managers' boards, and depositaries; disclosure to investors; and overcoming barriers to effective implementation.

The IOSCO Guidance draws on:

i. Existing relevant policy recommendations, including the IOSCO LRM Recommendations, the FSB Recommendations (see below), and the IOSCO Open-ended Fund Liquidity and Risk Management – Good Practices and Issues for Consideration;

ii. A review of recent academic literature;

iii. The observed good practices of jurisdictions where funds currently use anti-dilution LMTs; and

iv. Engagement with industry stakeholders and academics through roundtables and other outreach.

Source: IOSCO – Anti-dilution Liquidity Management Tools – Guidance for Effective Implementation of the Recommendations for Liquidity Risk Management for Collective Investment Schemes – Final Report

The IOSCO Guidance is broken down into five elements:

- Element (i) – *Types of anti-dilution LMTs*. This includes swing pricing, dilution levies applied to large deals, dual pricing, and subscription and redemption fees (similar to dilution levies but are applied to all deals).
- Element (ii) – *Calibration of liquidity costs*. This includes:
  - *Explicit transaction costs* – Transaction costs charged to a fund for its sale and purchase of underlying assets, including brokers charges, taxes and settlement fees.
  - *Implicit transaction costs* – These are described by IOSCO "as costs incurred indirectly upon acquisition or disposal of assets by a fund … that may vary depending on, [for example], the asset in question and underlying market conditions". Included in implicit transaction costs is market impact, where a fund has the potential to affect an asset's liquidity in the open market due to the size of a sale/purchase. Here IOSCO recommends putting in place tools to predict the potential movement of the prices of the underlying assets of a fund, based on similar transactions, in similar circumstances, in the past. In theory this would help pre-empt any price difference between the valuation point of a redemption and the eventual sale of underlying assets.
- Element (iii) – *Appropriate activation threshold*. Here the IOSCO Guidance is intended to ensure anti-dilution LMTs are applied appropriately and prudently so as not to result in material dilution impact on the fund.
- Element (iv) – *Governance*. Here IOSCO provides guidance on: governance committees; skills, knowledge and data; committee recommendations and decisions; review and escalation processes; reporting to senior management or board; and depositary and external auditor roles.

- Element (v) – *Disclosure to investors*. Here IOSCO provides guidance on providing information to investors on the design and use of anti-dilution LMTs.

IOSCO concludes the IOSCO Guidance with suggestions on how the operators of open-ended funds can counter the negative perception of implementing LMTs. IOSCO also recognises that market-wide structural and operational barriers may still need to be overcome to fully implement the LMT Recommendations.

FSB

On the same day IOSCO published its Guidance, the Financial Stability Board (FSB) issued a report titled Revised Policy Recommendations to Address Structural Vulnerabilities from Liquidity Mismatch in Open-ended Funds (FSB Revised Recommendations).

The FSB's Revised Recommendations supersede Section 2 of the FSB's 2017 Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities (2017 Recommendations) and are intended to be read alongside the IOSCO Guidance (see above).

The FSB's Revised Recommendations are intended to incorporate lessons learned since the original publication of the 2017 Recommendations and focus on open-ended fund liquidity management.

The key changes are:

- *Recommendation 3* is amended to include new liquidity categories for funds that could be used to predetermine dealing frequency.

The new liquidity categories are:

Category 1: Funds that invest in mainly liquid assets. These funds could be daily dealing and the FSB expects dilution effects to be insignificant.

Category 2: Funds that invest in mainly less-liquid assets. Funds in this category could be daily dealing if the manager can prove that this is appropriate by demonstrating to the relevant authorities that it implements other anti-dilution LMTs.

Category 3: Funds that allocate a significant proportion of their AUM to illiquid assets. These funds would not be daily dealing or would have long notice or settlement periods.

Source: FSB – Revised Policy Recommendations to Address Structural Vulnerabilities from Liquidity Mismatch in Open-Ended Funds

Recommendation 3 also contains guidance on funds that don't fit into only one of the first three categories (e.g., a fund investing mainly in liquid assets but with a significant proportion in illiquid assets would come under Category 3).

The FSB provides additional guidance in what constitutes "mainly investing", suggesting that this is greater than 50% AUM, and "allocating a significant proportion", suggesting greater than 30% AUM, however, it makes clear that ultimately it is down to individual regulatory authorities to determine what levels are appropriate, in-line with their domestic liquidity frameworks.

The FSB defines "liquid" assets as those that are likely to be assets that are readily convertible into cash without significant market impact in both normal and stressed market conditions.

"Less liquid" assets are defined as those assets whose liquidity is contingent on market conditions, but they would generally be readily convertible into cash without significant market impact in normal market conditions. In stressed market conditions, they might not be readily convertible into cash without significant discounts and their valuations might become more difficult to assess with certainty.

"Illiquid" assets include those for which there is little or no secondary market trading, and buying and selling assets is difficult and time consuming (i.e., weeks or months, not days) even in normal market conditions.

Source: FSB – Revised Policy Recommendations to Address Structural Vulnerabilities from Liquidity Mismatch in Open-Ended Funds

The remaining recommendations are amended to include:

- *Recommendation 1* is unchanged however the FSB notes that work must be undertaken to close data gaps.
- *Recommendation 2* requires clearer public disclosures from managers of open-ended funds on the availability and use of LMTs in normal and stressed market conditions.
- *Recommendation 4* emphasises the need for authorities to ensure the availability of a broad set of anti-dilution and quantity-based LMTs for use by managers of open-ended funds in normal and stressed market conditions.
- *Recommendation 5* seeks to achieve (i) greater inclusion of anti-dilution LMTs in open-ended fund constitutional documents and (ii) greater use of, and greater consistency in the use of, anti-dilution LMTs in both normal and stressed market conditions.
- *Recommendation 6* is amended to remove out of date instructions to IOSCO.
- *Recommendation 7* is amended to remove references to "exceptional circumstances" and replace them with "stressed market conditions."
- *Recommendation 8* ties in with the IOSCO Guidance and instructs regulators to provide guidance, based on IOSCO's work, on how to implement LMTs.
- *Recommendation 9* is unchanged.

European Union

The European Commission has recently approved the text of a directive amending the Alternative Investment Fund Managers Directive (AIFMD) and the Undertakings in Collective Investment in Transferable Securities Directive (UCITS) to include requirements for fund managers to implement LMTs.

To enable managers of open-ended funds based in any Member State to deal with redemption pressures under stressed market conditions, they should be required to select and include in the fund's rules or instruments of incorporation at least two liquidity management tools from the harmonised list set out in the amended directives.

However, funds complying with the European Money Market Funds Regulation will be required to select only one liquidity management tool from that list.

Those liquidity management tools should be appropriate to the investment strategy, the liquidity profile and the redemption policy of the fund. Managers of open-ended funds should activate such liquidity management tools where necessary to safeguard the interests of the fund's investors. In addition, managers of open-ended funds should always have the possibility to temporarily suspend redemptions and subscriptions or activate side pockets in exceptional circumstances and when duly justified having regard to the interests of the fund's investors.

When a manager of an open-ended fund takes a decision to suspend redemptions and subscriptions, it should without undue delay notify the competent authorities of its home Member State.

When the manager of an open-ended fund decides to activate or deactivate side pockets, it should notify the competent authorities of its home Member State in a reasonable timeframe prior to the activation or deactivation of that liquidity management tool.

A manager of an open-ended fund should also notify the competent authorities of its home Member State when activating or deactivating any other liquidity management tool in a manner that is not in the ordinary course of business as envisaged in the fund rules or the instruments of incorporation of the fund. This would allow supervisory authorities to better handle potential spill-overs of liquidity tensions into the wider market.

The tools include:

- Suspension of redemptions and subscriptions;
- Redemption gates (also known as deferred redemption);
- Extension of notice periods;
- Redemption fee;
- Swing pricing;
- Dual pricing;
- Anti-dilution levy;
- Redemptions in kind (also known as in-specie redemptions. The amended directives state that redemptions in kind are not appropriate for retail investors); and
- Side pockets.

The amended directives are expected to come into force during the first half of 2024 and will apply by 2026.

In addition to the amendments to UCITS and AIFMD, the European Commission, in its June 2023 request to the European Securities and Markets Authority (ESMA) to review the efficacy of the eligible assets directive (EAD), has questioned the thinking that listing an asset on an eligible market presumes that it is liquid, for the purposes of the UCITS Directive. ESMA has stated that it plans to issue a call for evidence on the review of the EAD by the end of Q2 2024, with a view to making technical recommendations to the European Commission in 2025.

US

In November 2022 the Securities and Exchange Commission (SEC) proposed rules that are intended to better prepare open-ended funds for stressed market conditions and mitigate dilution effects.

With the exception of money market funds and exchange traded funds, open-ended funds would be required to:

- Classify the liquidity of their assets and hold a minimum of 10% in highly liquid assets.
  - Rules relating to existing liquidity buckets within funds would be amended to include a requirement to hold more than 10% AUM in highly liquid assets and to treat all assets that take longer than seven days to settle as illiquid.
- Use swing pricing and implement a hard close.
  - Funds would be required to adopt swing pricing to mitigate dilution. In addition to taking account of market costs associated with underlying transactions, market impact costs would have to be factored in where net redemptions or sales exceed a threshold.
  - Funds would have to adopt a fixed pricing point to calculate prices.
- Provide more frequent, timelier, and more detailed public reporting of fund information, including information about the fund's liquidity and use of swing pricing.
  - Funds would have to submit monthly reports to the SEC within 30 days of the month end and make the report available to the public within 60 days of the month end.

The SEC is expected to publish the final rules, taking into account industry feedback, during 2024.

UK

In July 2023 the UK's Financial Conduct Authority (FCA) published the results of a multi-firm review of fund managers' use of LMTs. The FCA reviewed 14 authorised fund managers (AFMs) and concluded that the asset management industry is not doing enough to manage liquidity risks in collective investment schemes. The FCA's findings are broken down into the following five areas and contain details of its concerns as well as the good practices it observed.

Governance

Starting with Governance, the FCA found that AFMs are not attaching "sufficient weight to managing liquidity in their frameworks and governance structures". Overall, the FCA says, it would appear AFM boards and committees discuss liquidity only after it becomes an issue, whereas the FCA is looking for top-down management and oversight of liquidity in all situations.

Among its observations, the FCA says there needs to be:

- "Thorough scrutiny of the least liquid 'buckets' for liquidity, portfolio turnover, valuation, and use of dilution adjustments." It should be noted that the FCA does not define what a liquid, or less liquid, asset is.
- "The willingness to challenge investment managers about their funds' liquidity and the composition of portfolio transactions undertaken to meet investor redemptions. "

Last of all, the FCA recommends "building consideration of longer notice periods or redemption tenors for funds with a high proportion of less liquid assets into product governance".

Liquidity stress testing.

Here the FCA found that approaches to stress testing methodologies varied from highly sophisticated in-depth models to basic tick-box exercises.

The FCA points out flaws in assuming liquid assets will be easily sold (and what liquid assets are) and that if a fund never fails a stress test that doesn't mean the fund is liquid, it means the stress test is flawed.

Here the FCA's good practices include implementing ESMA's guidelines on stress testing in full, testing the entire portfolio, not 'most liquid first', and greater variation in the redemption scenarios used for testing.

Redemption processes
The FCA says that it found that there was "very little oversight from the AFM over whether customers are treated fairly" when redeeming their investment. Any enhanced oversight would only be triggered in the event of large redemptions.

The FCA's good practices also include:

- Considering the impact of redemptions on remaining investors;
- Pre- and post-redemption liquidity tests;
- "A process for consideration of alternative solutions to meet sudden large redemptions in funds with a concentrated portfolio or investor base or both"; and
- "War gaming" to simulate large redemptions.

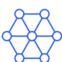
Liquidity Management Tools
The FCA's findings for LMTs focus on swing pricing, which it says could be used more effectively. The good practices include; calculate dilution on a fund-by-fund basis, back test prices to enhance valuation process (and that the fund operator should undertake the back-testing itself and not rely on the fund administrator), and report regularly to the board.

The FCA also mentions market impact cost, as discussed in detail by IOSCO in its Guidance.

Valuation
Here the FCA says that processes are reasonably robust but there is a lack of internal challenge. As a result, the good practices revolve around the establishment of independent valuation committees, board oversight, challenging third-party valuation services and, again, ensuring a link between asset liquidity and redemption periods.

So, what does the FCA expect?

Good governance.


Governing bodies to be composed of members with sufficient expertise, who receive timely and appropriate management information about risk, and who actively oversee issues, such as liquidity risk.

Asset managers to have robust governance arrangements to effectively oversee liquidity risks.

Firms to consistently use liquidity stress testing and employ liquidity management tools appropriately.

Firms to implement the good practices as they may help AFMs deliver good outcomes to retail customers, in keeping with the FCA's new Consumer Duty.

Alongside the review findings the FCA issued a Dear CEO letter which summarises the review findings. The FCA is forthright in its expectations stating, "We expect you to review your firm's liquidity management arrangements, consider the application of our findings in our review, and make any necessary enhancements."

The Netherlands

On 4 September 2023, the Dutch Authority for the Financial Markets (DAFM) and De Nerderlandsche Bank (DNB), who between them supervise compliance with rules for liquidity risk management that apply to managers of AIFs and UCITS in the Netherlands, published a letter addressed to boards of Dutch investment funds, detailing the findings of a DAFM survey into the availability and use of LMTs.

The DAFM found that most investment funds reviewed have access to at least three LMTs however, it says, fund managers should note the following observations:

1. Certain funds only have a limited number of LMTs at their disposal and in some cases do not have the possibility to suspend redemptions.
2. The AFM observed discrepancies between the survey response and AIFMD reporting.
3. Some responses in the survey appear the result of an erroneous interpretation of the term activated LMT.
4. The notification period for some funds – especially for illiquid funds – appears to be short.

Source: DAFM/DNB Sector Letter

Singapore

On 12 October 2023, the Monetary Authority of Singapore (MAS) published the information paper "Strengthening Liquidity Risk Management Practices for Fund Management Companies" setting out MAS' supervisory expectations of effective liquidity risk management frameworks and practices, including key findings from MAS' thematic liquidity inspections and review of prospectuses, which focused on collective investment schemes (CIS) offered to retail investors.

MAS states that firms should review their liquidity risk management frameworks and practices, taking account of the size, scale and complexity of their businesses and the risk profiles of the CIS that they manage.

Where firms observe gaps in the framework and practices, specific remediation/enhancement measures should be identified and implemented in a timely manner. Firms should also continuously enhance the frameworks and practices in a risk based and proportionate manner.

The information paper covers governance, initial design of products, ongoing liquidity risk management, and stress testing. MAS' key takeaways are:

Governance

- Ensure board and senior management (BSM) are kept apprised of all relevant liquidity risk matters on a timely basis;
- Ensure all liquidity risk related matters are reviewed and approved by individual(s)/committee(s) that include individual(s)/committee member(s) who are independent of portfolio management function; and
- Take greater care in reviewing information submitted/presented to BSM to ensure decisions are based on accurate and complete information.

Initial Design of Product

- Firms should conduct proper assessments on the applicability of LMTs, including anti-dilution tools such as swing pricing, to better manage liquidity risk of CIS and ensure fair treatment of all investors;
- Put in place necessary processes, including appropriate checks and balances, to ensure proper and timely implementation of relevant LMTs;
- Ensure assessments and decisions relating to the oversight and implementation of LMTs are properly documented;
- Conduct proper due diligence on service providers to ensure they are able to effectively support the fund management company (FMC) in its management of liquidity risk and implementation of LMTs prior to their appointments and on a regular basis thereafter; and
- Provide sufficient information to investors on the terms, circumstances and implications (e.g., impact on investors' redemption rights) of applying LMTs for informed decision making.

Ongoing Liquidity Risk Management

- Critically assess the range and relevance of liquidity metrics to be adopted and reasonableness of the assumptions used;
- Exercise due care when computing liquidity metrics and adopt a consistent definition and computation approach across different documents or within the same document and across CIS. Any deviation should be justified and properly documented;
- Conduct timely reviews, including obtaining feedback from relevant parties on the reasonableness of underlying assumptions used to compute different liquidity metrics and/or the computed liquidity scores via a vis actual markets conditions and make appropriate adjustments where necessary;
- Provide adequate guidance to staff on liquidity risk management practices such as setting out clearly the liquidity metrics and thresholds/limits used for monitoring and the corresponding follow up actions, including possible escalation, should the thresholds/limits be breached;
- Review investors' historical redemption patterns and expected future liquidity demands of the CIS under varying market conditions to assess the profile and liquidity needs of investors (e.g. engage key investors so that it is aware if they intend to make any large redemptions) and take appropriate steps to manage the redemption in an orderly manner; and
- Assess and evaluate the liquidity of the underlying assets of the CIS (individually and on a portfolio basis) under varying market conditions regularly. FMCs could analyse variations in spread and/or price volatilities (based on the underlying assets of the CIS) under stressed and normal market conditions to better proxy actual transaction cost across time and different market developments.

Stress testing

- Critically assess the calibration for the different stress factors in a hypothetical stress testing scenario;
- Ensure stress factors are consistently applied to all assets of a CIS during stress testing unless exceptions are necessary. If so, the justifications for doing so should be properly documented; and
- Ensure the liquidity risk management policies and procedures provide adequate guidance to staff on stress testing matters to ensure consistent implementation.

A tale of two fund types

As well as the liquidity of all open-ended funds, regulators have been targeting the liquidity arrangements of two specific fund types that usually sit at opposite ends of the liquidity spectrum; money market funds (MMFs) and property funds.

MMFs
In its thematic note on money market funds during the March-April 2020 episode, IOSCO describes MMFs as investment funds that seek to preserve capital and provide daily liquidity. However, during the period covered by the note, the ability of MMFs (particularly those invested in non-public debt) to meet their liquidity targets was put to the test with funds in the US and EU facing significant outflows.

MMFs were already subject to significant regulation aimed at protecting liquidity. In the EU, following market events in 2008, the Committee of European Securities Regulators produced guidelines for UCITS and non-UCITS MMFs that introduced a common definition of European MMFs with the purpose of improved investor protection with the aim of ensuring investors' expectations of being able to withdraw their capital on a daily basis. These guidelines were later adopted by ESMA and formed the basis for the EU Money Market Fund Regulation in 2017.

In the US, the SEC amended the Investment Company Act (the Act) in 2010 with the aim to reduce interest rate, credit and liquidity risks within MMFs. The Act was further enhanced in 2014 to address MMFs susceptibility to heavy redemptions under stressed conditions and reduce the potential contagion effect of such redemptions.

In July 2023, the SEC introduced a liquidity fee requirement that means MMFs must impose mandatory fees when a fund experiences daily net redemptions that exceed 5% of net assets, unless the fund's liquidity costs are negligible. It also gives a fund's board the discretion to impose a fee if necessary.

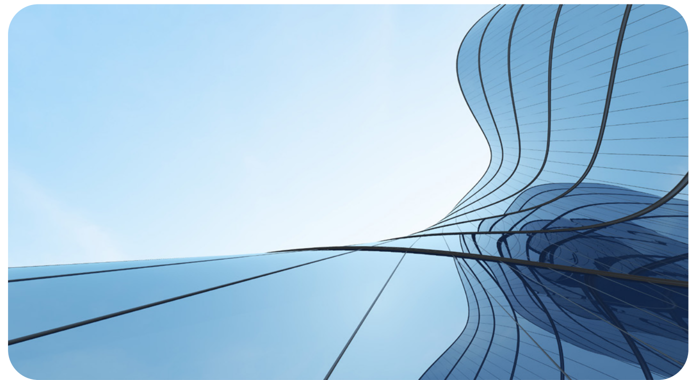
Other jurisdictions likewise introduced changes to their MMF rules, such as shorter maturity limits and imposing liquidity buffers. IOSCO published recommendations for common standards for the regulation and management of MMFs in 2012.

However, the events of 2020 raised concerns that the very rules introduced to protect the liquidity of MMFs, such as gates and redemption buffers, were in fact influencing investors to get out of funds before the thresholds that trigger these tools were breached. These concerns prompted the FCA, in its December 2023 consultation paper as part of the UK Government's delivery of the Smarter Regulatory Framework for financial services, replacing retained European Union MMF regulations with an approach to regulate MMFs tailored to the UK, to propose the removal of the link between liquidity levels in constant net asset value MMFs and the need for the manager to consider or impose LMTs such as fees or gates.

Property Funds
Open-ended funds investing in immovable property, such as real estate, have long been a source of concern to regulators, with fund failures due to liquidity issues dating back to the 1990s.

In more recent years concerns have been expressed by various regulators over the number of open-ended, daily dealing funds, that have been forced into suspension due to investors' expectations that they can redeem their holdings at a moment's notice.

This has resulted in regulators encouraging AFMs to move to less frequent dealing in line with the liquidity of the underlying assets, and to ensure investors understand the nature of those assets and the issues associated with their sale and purchase. It seems that far from being an entry into the world of commercial real estate investment, collective investment schemes have become an insulator between investors and the assets they want exposure to.



To see how attitudes have changed in the last 15 years, in 2008 IOSCO published a review of regulatory issues relating to real estate funds which stated that there were no serious problems with real estate funds in members' jurisdictions. By 2018 IOSCO was recommending that the dealing frequency of open-ended funds reflects the liquidity of the underlying assets.

However, changing the way property funds manage liquidity has not proved easy. For example, in the UK the FCA proposed obligatory notice periods for property funds in a consultation paper published in August 2020. As at the date of writing this article the final rules are still outstanding, with the FCA promising completion of the work some-time in 2024.

In the meantime, the FCA published rules on the Long-term Asset Fund (LTAF).

LTAFs are designed to hold at least 50% of their value in illiquid assets or other assets that need to be held over the longer term. LTAFs should have a redemption frequency that aligns with the liquidity of the underlying assets and in any event are prevented from redeeming units more frequently than once a month and must have a 90-day notice period.

Originally launched as a fund type aimed at pension funds and professional investors, LTAF's have subsequently been extended to retail investors (albeit as a restricted mass-market investment with restrictions on the marketing and availability of the product).

Looking Forward
So, it has certainly been a busy period recently. In the space of three months in 2023 we saw publications from IOSCO, the FSB, the UK's FCA, the Dutch AFM and the MAS.

Clearly, the issue of liquidity mismatch in collective investment schemes is not going away anytime soon as regulators globally attempt to introduce rules that attempt to mitigate its impact.

And it's important to note that regulators are not acting in isolation. At a recent meeting of the joint EU-UK Financial Regulatory Forum, the EU and UK participants shared their respective positions on the ongoing FSB work aiming to promote the implementation of its liquidity management proposals.

Also, the results of the FCA's multi-firm review of fund managers' use of LMTs informed its input into the IOSCO Guidance.

And despite their best efforts, regulators will not be able to legislate liquidity mismatch out of existence. It will aways be down to CIS operators to decide the appropriate dealing frequency of the fund for the underlying assets and the LMTs to be employed to mitigate against any mismatch that may still occur.

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