CONSULTATION RESPONSE

Brussels, 4 September 2023

EFAMA's RESPONSE TO THE IOSCO CONSULTATION REPORT ON ANTI-DILUTION LIQUIDITY MANAGEMENT TOOLS

Introduction

EFAMA welcomes the IOSCO Consultation report which we believe is a good starting point for further engagement with our industry on dilution in Open-Ended Funds (OEFs). We believe that dilution may indeed trigger investor protection concerns for certain funds and welcome, in this respect, IOSCO's commitment to protect end-investors from material dilution. This being said, we however do not support the consultation report's significant emphasis on financial stability considerations. Although liquidity risk management can support the resilience of a fund and, thus, the robustness of the broader sector, it would be unsubstantiated and disproportionate to derive the conclusion that fund liquidity risks would inevitably lead to financial stability ones.

While recognising that the draft Guidance could contribute to greater convergence over the long-term, we welcome the fact that IOSCO acknowledges the diversity of the OEF sector and the important jurisdictional differences in terms of regulatory approaches. A (global) 'one size fit all' regulatory approach would not be feasible, as OEFs are exposed to very different asset classes and pursue different investment strategies, have different investor bases, and operate in local regulatory ecosystems that require different approaches to liquidity management. We therefore contend that management companies should retain the discretion to select – in discussion with their national supervisors – the Liquidity Management Tools (LMTs) that are the most appropriate for the funds under their management.

The IOSCO draft Guidance represents a broadly accurate depiction of the liquidity risk management framework that every asset manager should put in place to monitor, and where relevant address, dilution in the investment funds under their management. We therefore agree with the overall principles and goals of the suggested framework. At the same time, there are some areas where we would suggest further improvements to better align the draft Guidance with the inherent diversity of the OEF sector, the dynamic nature of risk management, and the interests of end-investors. These concern the following aspects of the consultation report: 1) the potential use of anti-dilution tools (ADTs) for financial stability purposes, 2) the obligation for each OEF to have at least one ADT, 3) the systematic consideration of implicit transactions costs (and in particular the 'market impact'), and 4) excessively granular disclosures to end-investors.

We wish to reiterate the necessity to see this draft Guidance as a set of best practices that all management companies should strive to reach in the medium to long-term, taking into account existing differences across funds and jurisdictions. As further outlined below, there are indeed indications that some funds already use other LMTs (such as quantity-based ones), while facing, in aggregate, low levels of dilution. Moreover, in some jurisdictions, there are also different liquidity management approaches that would render compliance with some parts of this draft Guidance counterproductive, or even impossible.

On the timing of this consultation (in parallel to the accompanying FSB consultation addressing alleged vulnerabilities from liquidity mismatches in OEFs), and while mindful of the broader G20 agenda, we regret that these consultations are (again) poorly-timed (i.e. in the middle of a holiday season), which inevitably goes at the expense of deeper insights that our industry's practitioners could have had offered to global standard-setters.

The primary responsibility of asset managers

Management companies should have the discretion, in discussions with their national supervisors (upon a fund's authorisation and on an ongoing basis where appropriate), to select the most relevant LMTs for the investment funds under their management. We, therefore, welcome IOSCO's acknowledgment that "*Responsible entities have the primary responsibility and are best placed to manage the liquidity of their OEFs. As such, the proposed guidance neither prescribes a specific calibration for each anti-dilution LMT nor specifies which tool should be used or when. Instead, it sets out key operational, design, oversight, disclosure and other factors and parameters that responsible entities should consider when LMTs are used, with a view to promoting their greater, more effective and more consistent use. As the OEF sector is very diverse, there is no 'one size fits all' solution regarding liquidity risk management, including the use of anti-dilution LMTs*".[1]

While the draft Guidance states that it is not IOSCO's intention to dictate which ADTs a fund should select, it is our belief that **the Guidance remains too prescriptive and would *de facto* result in an mechanical take-up of ADTs, regardless of the specific situation of the fund**. As further developed below, based on the observation that dilution is relatively low among many funds, it would for instance be questionable to require each OEF to have at least one ADT. We will further outline, in our assessment of the individual draft Guidance, how IOSCO could proceed to make its future Guidance more compatible with the broad diversity of the OEF industry.

To ensure that all management companies comply with minimum liquidity risk management requirements, national supervisors will naturally play a crucial role in setting minimum requirements at a local level and by ensuring their proper application by management companies. Regarding minimum local requirements, we note that in the EU, following the recently finalised review of the AIFMD and UCITS Directive, the European Securities and Markets Authority (ESMA) is expected to adopt regulations and guidelines to further define available LMTs, provide guidance on the use of these tools, and specify how management companies should disclose information on these tools to end-investors.[2] Concerning local enforcement, national supervisors will continue to play an essential role in guaranteeing, at the fund's launch, that all OEFs have, where relevant, the sufficient ADTs to reduce foreseeable material dilution. In conclusion, while IOSCO's final Guidance should remain sufficiently principle-based to allow national supervisors to adapt this Guidance to the specific situation in their respective jurisdictions, EFAMA would nonetheless see value in IOSCO providing concrete examples that would help national supervisors, especially in jurisdictions where the use of ADTs is less common, to learn

[1] IOSCO, Consultation Report on Anti-Dilution Liquidity Management Tools, July 2023, pp. 8-9.

[2] As the EU co-legislators have found a political agreement in July 2023, the legislation is expected to be published towards the end of 2023. In the meantime, please refer to the Council's position and the European Parliament's Report for an overview: Council of the European Union, Position on the AIFMD/UCITS Review, June 2022; European Parliament, Report on the AIFMD/UCITS Review, May 2023.

about anti-dilution management in such a way that they would be in a position to ask the right questions to management companies and, where necessary, to challenge their liquidity management practices.

The objective of anti-dilution tools

Before further discussing each draft Guidance individually, we wish to reiterate that **ADTs are in essence investor protection tools and should therefore not be construed as tools intended to guarantee financial stability.** Unlike quantity-based LMTs such as suspensions or gates, ADTs are not designed to manage the size of a fund's subscriptions and redemptions, but rather to ensure that subscribing or redeeming investors pay for most, if not all, costs associated with the purchase or sale of the fund's underlying assets.

For funds investing in less liquid assets such as corporate bond funds, we believe that these tools would limit the risk that certain sophisticated investors may opportunistically choose to exit these funds ahead of other investors. However, as outlined above, there is no evidence at this stage that this is a noticeable phenomenon that could have market-wide repercussions. We therefore conclude that, while ADTs may reduce the level of outflows from a few funds, this would not make a sufficient difference to argue that these tools would contribute to strengthening the resilience of the financial system.

Quantity-based LMTs are, in our view, more suitable to deal with large outflows which could result in a market impact unforeseen by the redeeming investors. Recent studies on the resilience of the EU corporate bond fund sector demonstrate that, during a period of market stress, outflows are not equally distributed across funds and that some may face significantly larger redemptions than the average corporate bond fund. For instance, according to our estimates, 25% of EU high-yield corporate bond funds faced redemptions equal or higher than 12,5% during March 2020. A smaller subset faced redemptions ranging between 25 and 50% during this same period.[3] It is therefore reasonable for regulators to ask how a management company would react to such a situation.

While the nature of the reactions will necessarily differ from one fund to the other depending on their respective characteristics, it is our view that, in many cases, it would be more appropriate for managers to consider *ex-ante* quantitative limitations on redemption rights (e.g., a maximum redemption right of 5 to 8% *per annum* as in the case of the recently reviewed EU ELTIF regime), or the *ex-post* gating of the fund. Both would avoid a situation where the fund could be forced to either sell its assets at a significant discount, or suspend redemptions and subscriptions, with lasting consequences for the managers' reputation and for the fund's future viability. Indeed, ADTs will not prevent investors from redeeming their units or shares during periods of stress. In this regard we agree with IOSCO that *"[i]f responsible entities cannot be confident that the assets are valued fairly or cannot reasonably estimate the cost of liquidity for these assets, especially in stressed market conditions, the use of quantity-based LMTs and other liquidity management measures (applied in accordance with local regulations), such as side pockets, suspensions, longer notice or settlement periods or reduced redemption frequencies, may be more suitable than the use of anti-dilution LMTs."*[4] In our view, this is particularly relevant for large retail funds as we share IOSCO's and FSB's concern that "*some investors may misunderstand the liquidity of the underlying assets held by OEFs and may not expect the additional cost or difficulty associated with funds exiting their positions, especially in a stressed environment"*.[5] For these funds, were redemptions to reach exceptional levels due to broader market developments, the activation of an ADT could result in significantly higher transactions

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[3] EFAMA, Open-Ended Funds and Resilient Capital Markets, July 2023, pp. 38-42; See also the following report for similar findings: ESMA, Report on liquidity risk in investment funds, November 2020, p. 24.

[4] IOSCO, Consultation Report on Anti-Dilution Liquidity Management Tools, July 2023, p. 16.

costs than initially foreseen by the redeeming retail investors. By activating a quantity-based LMT instead, the management company would therefore better protect these investors from harm.

Questionable analytical foundations

Although we believe that macroprudential supervision should be a core feature of any developed capital market, we believe that these types of analyses are not yet sufficiently developed and are often predicated on inaccurate assumptions. In the current case, the whole rationale for greater scrutiny in OEF liquidity management stems from the questionable assumption that the very structure of OEFs encourages pro-cyclical redemptions by end-investors, which in turn would result in so-called 'excess' sales.

In our recent position paper *Open-Ended Funds & Resilient Capital Markets*, we have extensively demonstrated that **the focus on OEFs as part of the FSB's NBFI agenda is largely misguided**. According to the FSB, OEFs would account for more than 70% of the so-called 'narrow NBFI measure'.[6] Such estimate is nevertheless derived from simplistic assumptions and risk measures that repeatedly fail to grasp the fundamental differences between OEFs and bank deposit accounts.[7] The measure that is used to justify the claim that there would be a 'structural liquidity mismatch' in the OEF sector is moreover inappropriate because it grossly overestimates the propensity of investors to redeem. What many academics have called a 'first-mover advantage' in OEFs investing in less liquid assets (e.g., corporate bonds) is rather the reflection of a market-wide first-mover advantage in less liquid markets.[8] As regards whether there is such a first-mover advantage in the OEF sector, there is ample evidence to demonstrate that the level of dilution in OEFs invested in equity and fixed-income securities is relatively low, even during periods of market stress.[9] While March 2020 is often cited as a case study to demonstrate the potentially destabilising effects of OEFs on capital markets, it appears that even the fund category that saw the largest outflows in Europe during this period (i.e., corporate bond funds) showed high levels of resilience and ability to meet outflows using existing LMTs. In contrast to what is often assumed, many European corporate bond funds experienced limited outflows during the period and, moreover, these flows occurred in small and incremental sizes over the month. This evidence invalidates the usual narrative according to which OEFs would engage in fire sales due to large and unforeseen redemptions.[10]

In this respect, we note that while financial risks have recently materialised with multiple bank failures in March 2023, preceded by the UK Liability-Driven Investment (LDI) crisis in September 2022, as well as the by earlier Archegos debacle in March 2021, there have been no failures of similar magnitude in the European investment fund industry. While investment funds did experience large outflows during March 2020, these reflected the 'risk-off' sentiment of end-investors during the exceptional circumstance of a stalling global economy.

EFAMA would therefore strongly recommend that IOSCO and national market supervisors conduct more in-depth studies in order to have a better overview of the effective levels of dilution in the OEF sector.

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[6] FSB, Global NBFI Monitoring Report, December 2022, p. 3.
[7] EFAMA, Open-Ended Funds and Resilient Capital Markets, July 2023, pp. 18-19.
[8] Op. Cit., pp. 34-38.
[9] ICI, Setting the Record Straight on Dilution, First-Mover Advantage, and Financial Stability Risk, June 2023.
[10] EFAMA, Open-Ended Funds and Resilient Capital Markets, July 2023, pp. 38-41.

EFAMA views on the IOSCO ADT draft Guidance

Proposed Guidance 1 – Overall Framework

EFAMA agrees that every OEF should have an appropriate risk management framework that allows the management company to evaluate whether the fund faces material dilution. To this end, the management company should evaluate at sufficient intervals whether the funds under its management are experiencing some degree of dilution.

The draft Guidance should not require each OEF with daily dealing to consider dilution on a daily basis because not every OEF faces sufficient dilution to warrant a full-fledged anti-dilution framework. There is evidence to suggest that some funds may face very low dilution (e.g., blue chip equity funds), while others (e.g., government bond funds) may face slightly higher dilution but still too low to justify the additional costs associated with a full-fledged anti-dilution arrangement (especially when we consider the important costs associated with measuring implicit transactions costs). Moreover, an anti-dilution arrangement may not be relevant for funds investing in illiquid assets, as these funds would tend to use quantity-based LMTs that would reduce the relevance of ADTs. For instance, real asset funds that use notice/settlement periods will be able to spread their sales over time and, when faced with large redemptions, would typically and more appropriately use a side pocket (especially where assets cannot be sold other than at a very deep discount). Similarly, a full-fledged anti-dilution arrangement would not be relevant for single-investor funds and would be of limited added-value to institutional funds where the management company has the possibility to contact the redeeming investors and activate gates with relatively low thresholds.[11]

OEFs which implement/use ADTs should have an appropriate anti-dilution framework in place. As outlined below, in our assessment of draft Guidance 4, it is nonetheless important to allow for the use of activation thresholds to ensure, firstly, that the subscribing or redeeming investors pay a fair price for the acquisition or sale of their shares/units; secondly, to reduce the costs associated with the activation of the ADT; and thirdly, to reduce NAV volatility.

Proposed Guidance 2 – Types of Anti-Dilution LMTs

While we agree that all OEFs that implement/use ADTs, should have an appropriate anti-dilution framework in place, **we would question the necessity to have such a requirement for every OEF**. Notwithstanding the reasons already outlined above, this requirement would be incompatible with the European legislation, which does not mandate the use of any specific LMT. The recent AIFMD/UCITS review requires each fund to not only have the right to suspend redemptions but also to have access to two more LMTs that management companies can select from an exhaustive list of quantity- and price-based LMTs.

Moreover, when evaluating whether ADTs are consistently adopted, it is important to remember that dilution may vary from one fund to the other according to the fund's size, investment strategy, underlying assets, and investor base. It is therefore possible that funds within a same risk profile may have different LMTs

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[11] The ESMA 2022 AIF Statistical Report indicates that "The ownership of [EU's Alternative Investment Funds (AIFs)] continues to be highly concentrated: the top five investors account for more than 75% of the NAV across AIF types. More than 50% of all AIFs are entirely held by their top five investors […]. The high ownership concentration is explained by the dominant role played by institutional investors. In some cases, AIFs can be set up for a single institutional investor that prefers to hold all of the AIF shares, as the fund can be set up to fulfil its specific investment objective." (p. 12).

available in their toolbox. For instance, for an index fund, even low levels of dilution may be considered as material in light of the low management fees and the necessity to closely track the index.

Proposed Guidance 3 – Calibration of Liquidity Costs

EFAMA agrees that OEFs that implement/use ADTs should calibrate these to factor in explicit and, to the extent possible, implicit transaction costs. As regards the latter, and only when these costs are relevant for a given fund, the calibration of ADTs to these transactions costs should be done on a best-effort basis considering the inherent difficulties in estimating these costs and the fact that, at this stage at least, only a minority of management companies have the capacity to estimate market impact and usually only for the most liquid asset classes.

Management companies should not have to consider implicit transaction costs when they have sufficient assurances that their trades would not result in such transactions costs. For instance, this could be the case when flow patterns in a fund indicate that, even under market stress conditions, trade sizes are well below the market participation rate (that is the tradable volume under which there is no significant impact on prices) or when the fund has the possibility to activate a gate with a sufficiently low activation threshold to avoid any market impact.

It is important to acknowledge that **measuring liquidity is 'more an art than a science', in the sense that measuring implicit transaction costs can be a difficult task for either methodological or operational reasons.** First, as regards the measurement of the **bid-ask spread**, it is operationally difficult in the EU to collect and aggregate the spread for fixed-income securities considering the fragmentation of the European bond market. Second, as regards the measurement of **market impact**, it is crucial to have access to a set of data points such as prices, trading volumes, and the participation rate (i.e., how much the fund's holdings account for in proportion to their assets' total respective amounts outstanding) to determine how much assets a fund can sell without impacting the underlying market. It must be recognised that no management company can reasonably know how other market actors will choose to behave under stressed market conditions, including critical information around the latter's trading patterns, holdings, execution prices and lot sizes, to name only a few. As a result, when estimates of implicit costs, or of market impact more specifically, are being carried out by a few large firms, these are commonly limited to only the most liquid asset classes, namely equities, for which data can be sufficiently available. The dearth of available and reliable market data across multiple jurisdictions, actors and asset classes is such at present that any trustworthy and systematic consideration of market impact is plainly not achievable, leading us to the conclusion that it would not be appropriate to expect management companies to measure market impact for every OEF that may face dilution.

In light of the above, IOSCO suggests that management companies should rely on their *"professional judgement, trading experience and best efforts to arrive at a reasonable estimate"* and that ADTs "*should be calibrated conservatively"*. To promote consistency, IOSCO notably proposes to estimate the liquidity costs on the assumption that a fund would sell a pro-rata slice of its underlying assets (i.e., vertical slicing).[12] In line with the acknowledgement that implicit transactions costs are not relevant to all OEFs and that estimating these transaction costs requires a 'professional judgment', we believe that **IOSCO should not expect all management companies to calibrate their ADTs in the same way**. **Furthermore, we question the idea that management companies should conservatively estimate transaction costs**, regardless of whether it is intentional, or the result of a methodology mandated by regulators. As an illustration, requiring management companies to estimate transaction costs paid by the funds on the assumption that every single fund experiencing outflows would vertically slice its portfolio would inevitably

[12] IOSCO, Consultation Report on Anti-Dilution Liquidity Management Tools, July 2023, pp. 16-18.

result in a series of 'false positives' where the estimated liquidity costs would effectively exceed those paid by the fund. There are indeed many OEFs that do not vertically slice their portfolio to meet outflows. For example, some funds meet redemptions by using their cash buffer/credit line, or by selling the assets that they no longer need (e.g., when implementing a shift in their investment strategy). The former type would bear no, or at least limited, transaction costs, whereas funds of the latter type would inevitably bear the related transaction costs. Overcharging certain investors would contravene a manager's fiduciary duty and could also result in legal actions were these to demand compensations. Moreover, in certain jurisdictions, managers already face significant scrutiny from supervisors about the assumptions made in the calibration of their ADTs. The rationale is to ensure that these ADTs are not used to boost a fund's track record by creating windfall gains for the fund at the expense of redeeming investors. As a result, it would be difficult to apply conservative estimates in light of the supervisory approach taken in these jurisdictions.

Proposed Guidance 4 – Appropriate Activation Threshold

EFAMA welcomes the recognition by IOSCO that management companies should be able to use activation thresholds to avoid having to use ADTs daily. This is particularly relevant in the case of swing pricing, considering how resource-intensive it is to calculate swing factors and the additional volatility in the price of the fund's shares/units that a full swing pricing methodology would imply. As regards the tiered swing pricing model, we note that, while some management companies already use such model, implementing such approach may be operationally quite complex, requiring a certain level of sophistication that some management companies and other essential actors in the fund ecosystem (i.e., depositories and fund administrators) may not currently possess.

Proposed Guidance 5 – Governance

EFAMA agrees that governance is the cornerstone of any risk management framework and we broadly support the internal governance arrangements highlighted in the draft Guidance. Considering that fund boards and risk management committees are already responsible for the proper management of liquidity in OEFs, we would nonetheless argue that it is **not necessary to have, in addition to these existing bodies, a dedicated anti-dilution committee.** We would add that the aforementioned governing instances should actively seek to ensure that the management companies under their oversight make, where necessary, incremental progress towards the best practices set out in the draft Guidance.

Proposed Guidance 6 – Disclosure to Investors

EFAMA agrees that management companies should provide sufficient information to end-investors to allow them to evaluate how OEFs deal with dilution.

Public disclosures should provide **qualitative information** to comfort investors that the value of their investments will not be impacted by dilution. This should include: 1) ADTs available to the funds and their description, and 2) the transaction costs considered.

Public disclosures should <u>not</u> provide information on the range of activation thresholds and/or adjustment factors to avoid 1) any potential arbitrage by sophisticated investors and 2) overburden retail investors with details that these would most likely not understand. While such disclosures may appear to be 'good practices', we believe they hide these important potential drawbacks.

When a maximum swing factor or fee are disclosed, the prospectus should indeed include a legal mention that the maximum adjustment factor or fee may be exceeded under stressed market conditions. Here, we care however to note that certain supervisors are not keen to leave such discretion to management companies and therefore often require quite detailed descriptions of circumstances under which swing factors could be activated, making it effectively very difficult to adapt the maximum swing factor or fee.

EFAMA would thus welcome the recognition in this draft Guidance that management companies should be able, with a reasonable degree of discretion, to calibrate ADTs to match the level of dilution in the OEF, whilst acknowledging that these tools should not be a source of windfall gains for the management company.

Overcoming Barriers and Disincentives

EFAMA agrees that there are indeed barriers and disincentives to the implementation of ADTs in Europe.

As regards **barriers**, we note that market fragmentation in Europe means that it is difficult and costly to have sufficient data to operationalise sophisticated ADTs for certain types of assets. This barrier could for instance be alleviated by the progressive development of a consolidated tape similar to the one available in the United States, now also underway in Europe after the recent conclusion of the EU MiFIR legislative review.

Concerning the **disincentives**, attitudes towards ADTs may sometimes markedly differ from one jurisdiction to another. In some jurisdictions, the adoption of ADTs may be particularly difficult because, while institutional investors do not wish to invest in funds that use swing pricing, retail investors are less likely to invest in funds that use redemption fees, as these are viewed as yet another potential charge to pay.

ABOUT EFAMA

EFAMA is the voice of the European investment management industry, which manages EUR 28.5 trillion of assets on behalf of its clients in Europe and around the world. We advocate for a regulatory environment that supports our industry's crucial role in steering capital towards investments for a sustainable future and providing long-term value for investors. Besides fostering a Capital Markets Union, consumer empowerment and sustainable finance in Europe, we also support open and well-functioning global capital markets and engage with international standard setters and relevant third-country authorities. EFAMA is a primary source of industry statistical data and issues regular publications, including Market Insights and the EFAMA Fact Book.

More information is available at www.efama.org

Contact:

Marin Capelle
Regulatory Policy Advisor
marin.capelle@efama.org | +32 2 548 26 50