THE
INVESTMENT
ASSOCIATION

Financial Stability Board (FSB)
Bank for International Settlements
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By email: fsb@fsb.org

4 September 2023

RE: Public Comment on Addressing Structural Vulnerabilities from Liquidity Mismatch in Open-Ended Funds – Revisions to the FSB's 2017 Policy Recommendations: Consultation Report

We welcome the Consultation Report and share the aim of strengthening liquidity management by open-ended fund (OEF) managers. We are responding to the FSB consultation alongside the IOSCO consultation on anti-dilution liquidity management tool (LMT) guidance, where we support the approach subject to some caution on the design of procedures to implement that guidance.

Our overall position is to fully support the widespread availability of anti-dilution, quantitative and other LMTs and agree that the manager is best place to adopt the appropriate tools for each particular fund. We are also supportive of the FSB stance that considers fund managers to be in the best position to determine and manage both dilution and the liquidity profile of the funds that they manage, recognising the particular nuances of each individual fund.

However, consistent with this view, we strongly disagree with the proposed construction of the bucketing approach for the following reasons.

First, and fundamentally, liquidity bucketing needs to be a holistic approach that considers both the market-based liquidity of underlying assets and wider relevant features of each particular fund, including the liability side. Considerations will therefore also include factors such as fund size; actual and target investor base; redemption history; liquidation strategy; and other funds and accounts managed by the same manager, which may be dealt on in conjunction.

Second, the terminology itself - 'liquid', 'less liquid' and 'illiquid' assets – is clear at a high level, but not helpful in practice. The operation of funds holding assets whose liquidity is changeable could experience very different conditions in stressed markets, where a very liquid market for an asset can suddenly become less liquid. This makes both management and disclosure in a three-bucket world challenging.

Third, distinctions between buckets based on the use of anti-dilution LMTs appears to confuse the cost of fund liquidity with the availability of liquidity in the market. Anti-dilution LMTs will protect investors from the effects of material dilution arising from differences between the mid prices used for fund valuations and market price spreads, and may disincentivise certain first mover behaviours that seek to take advantage of a fund's pricing structure. However, they will not significantly influence investor behaviour or help to manage a fund's liquidity profile. Different tools are needed to ensure that a fund remains

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sufficiently liquid to meet investor redemptions and protect the interests of all investors where this is not possible. This sits at the heart of considerations about the timing and scope of liquidity tool deployment, whether temporary (e.g. gating) or permanent (e.g. notice periods).

Following from this point, use of anti-dilution LMTs should be facilitated but not imposed as part of the liquidity management toolkit, and especially not through a bucketing requirement. The critical question for funds to consider is whether there is a risk of material dilution and how they may need to adapt their approach accordingly. This will mean that not all funds should have to use anti-dilution LMTs. However, the decision should be determined by anticipated dilution costs. In our view, this will in effect better align the FSB and IOSCO approaches. Quantitative and other LMTs should be used as appropriate for each individual fund's liquidity profile, which encompasses asset liquidity and the other factors detailed above.

Finally, we support effective disclosure of liquidity risk and the availability and use of LMTs as part of clear and accessible fund communication. This requires a careful balance between different factors. Material needs to be accessible and clear enough to help all potential investors, with different levels of knowledge understand the liquidity management tools that are available and how they would operate if required. At the same time, disclosures should not be so detailed that these constrain managers or could be used by more experienced investors to front run or game LMTs put in place by managers – in particular any requirement to specify a hierarchy/order of use, or examples of market scenarios where tools might be deployed, should be avoided.

We will be considering further how to overcome the challenges outlined in this letter and look forward to conversations with regulators to deliver shared objectives in a practical and effective manner.

Yours faithfully

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Response to consultation

ADRESSING STRUCTURAL VULNERABILITIES FROM LIQUIDITY MISMATCH IN OPEN-ENDED FUNDS – REVISIONS TO THE FSB'S 2017 POLICY RECOMMENDATIONS: CONSULTATION REPORT

About the Investment Association

The Investment Association (IA) champions UK investment management, a world-leading industry which helps millions of households save for the future while supporting businesses and economic growth in the UK and abroad. Our 270 members range from smaller, specialist UK firms to European and global investment managers with a UK base. Collectively, they manage £10 trillion for savers and institutions, such as pension schemes and insurance companies, in the UK and beyond. 46% of this is for overseas clients. In particular, UK-based firms manage $5.5 trillion for investment funds domiciled primarily in the UK (35%), Ireland (33%) and Luxembourg (15%). The UK asset management industry is the largest in Europe and the second largest globally.

Executive summary

The IA welcomes the FSB consultation to review the 2017 Recommendations on liquidity management in open-ended funds, in coordination with the IOSCO consultation on new guidance on anti-dilution liquidity management tools. While we support the overall aim of "significant strengthening of liquidity management by open-ended fund (OEF) managers compared to current practices," our response sets out some strong concerns about the proposed approach to liquidity bucketing and we urge the FSB to reconsider.

Scope of application

The IA agrees that the FSB Recommendations should not be applied to ETFs and MMFs for the reasons outlined by the FSB: that the characteristics of MMFs and how they are managed are very different from other OEFs and that the ETF structure and features naturally exclude them.

Responsibility for liquidity management and regulatory framework

The IA strongly supports the FSB's stance that managers of OEFs have the primary responsibility and are best placed to manage the liquidity of their portfolios. The features of each particular fund are unique and overly prescriptive regulatory requirements detailing a 'one-size-fits-all' approach would prove to be counterproductive.

We therefore agree that an effective international regulatory and supervisory framework should be high-level and flexible, to allow it to be incorporated into a wide variety of regulatory frameworks and allow different jurisdictions' liquidity regulations to achieve consistency with the revised Recommendations. To this effect, consistency could be achieved via a regulatory framework or guidance, rather than mandated application of thresholds.

We are in agreement that giving managers discretion brings with it certain responsibilities. We agree that all OEFs in scope should continue to enhance their liquidity management practices, including by, as appropriate, implementing anti-dilution, quantitative and other liquidity management tools (LMTs). Managers should review their practices and processes for liquidity management on a regular basis, particularly in light of any policymaker rule changes and reviews.

Consistent with this view, we fundamentally disagree with the proposed bucketing approach. The approach takes a highly stylised, and arguably over-simplified, view of funds' liquidity, focusing on assumed market-based liquidity of underlying assets, rather than taking a holistic approach. We would expect such a holistic approach to consider all the relevant features of each particular fund, such as:

- the cost implications of achieving a rapid sale and dynamism of asset liquidity;
- fund size, market or asset concentration;
- actual and target investor base;
- whether the fund has any non-redemption obligations, e.g. margin requirements, loan guarantees, capital commitments, etc;
- trading relationships available to the manager;
- redemption history;
- liquidation strategy; and
- other funds and accounts managed by the same manager, which may be dealt on in conjunction.

This proposed approach to bucketing is also contradictory to UK industry practice and wider principles of liquidity management, such as the ESMA Guidelines on fund liquidity stress testing. The industry would benefit from a more nuanced approach to creating a liquidity profile for an individual fund, reflecting the dynamic nature of liquidity in many parts of the market and wider features of the fund, all of which will determine room for manoeuvre in given scenarios. Given that liquidity is fluid, there could be scenarios whereby a fund routinely crosses the proposed thresholds and this could cause issues with both managing the fund's portfolio effectively and managing the fund's disclosures. Therefore, careful thought is needed on how this would be managed, for example the periodicity of reviewing the fund categories and updating them.

The IA considers that an effective approach to measuring the liquidity in a fund can use a bucketing approach to classify assets on a 'days to trade' basis as a starting point. However, we do not advocate the use of buckets defined at industry level by regulators either to set regulatory thresholds or for disclosure requirements. The number of buckets used to classify assets and the labels on those buckets should be determined by managers based on 'days-to-trade' on a fund-by-fund basis and incorporating the cost dimension of liquidity risk. This provides managers with the ability to tailor that approach to the liquidity profile of the fund, taking into account the market impact that increasing volumes of sales of that asset may have.

Other features of the fund should then be considered, to build a liquidity profile for the fund. The manager would then select the appropriate LMTs to manage the fund's liquidity. We do agree with the proposal that managers adopt a prudent approach to liquidity measurement and that any assumptions used should be capable of justification. This should not be read as disagreement of the adoption of a consistent approach, but as an advocacy of a framework, as opposed to rigid rules.

In addition, and explained in more detail below, redemption frequency is an important tool to manage fund liquidity, but not the only tool and changes to redemption frequency in funds holding less liquid assets would not resolve issues with liquidity without the use of other supporting tools, such as notice periods. In the UK, the OEF model, particularly administration and distribution is largely based on daily dealing and distributors tell product manufacturers this is investors' preference. We therefore argue that this proposal should not be considered in isolation ahead of IOSCO's consideration of quantitative and other LMTs in 2024. We look forward to engaging with IOSCO in this work.

Use of Liquidity Management Tools (LMTs)

The IA agrees that globally, the greater use of anti-dilution LMTs would be ideal to strengthen investor protection but note that the UK is more advanced in its use of anti-dilution LMTs than many other jurisdictions. We have developed guidance on anti-dilution LMTs[1] and explore the principles more fully in our response to IOSCO's consultation on anti-dilution LMTs, which is running concurrently with this consultation. As noted above, we see that global consistency could be achieved via a regulatory framework or guidance, rather than mandated application of an anti-dilution LMT. Guidance should take account of the fact that some LMTs, such as reduced redemptions and notice periods will be used on a day-to-day basis and some will be used only in times of stress – not just market stress but stress on the fund, e.g. large redemptions.

We also agree with the FSB's finding that there is very little consistency in available tools globally. Consistency in application would be problematic, as fund manufacture and distribution take many different forms in different jurisdictions. However, the aims and objectives of the industry globally are consistent: anti-dilution LMTs should protect the fund and continuing investors from material costs associated with large transactions resulting from investor subscriptions and redemptions, whereas quantitative and other LMTs can assist managers in effectively managing funds' liquidity, including liquidity mismatches between a fund's assets and its redemption terms. It is important to recognise the differences in these aims and objectives; we remain unconvinced that liquidity mismatches can be entirely resolved through the use of anti-dilution LMTs and we are unlikely to see a risk of market impact caused by dilution in all but a minimal number of cases.

We acknowledge that liquidity mismatch can be an issue and has occurred in a small number of historic cases, though this has rarely resulted in the transmission of any risks to the wider financial system. As detailed above, we look forward to the publication of IOSCO's consultation on quantitative and other LMTs in 2024 and will use the opportunity to continue to advocate for the availability of all LMTs at a national level, to be selected and used by managers as appropriate for each individual fund. Such tools, including redemption frequency, can be used in isolation, or in conjunction with other tools to manage liquidity in a fund as considered suitable when taking all characteristics of the fund into account. It is important to appreciate that suspension is an important and valid LMT that is used by OEFs to protect investors. The aim of OEF liquidity management should not be to avoid suspension at all costs.

As detailed in our comments on Recommendation 4, it is important that managers build, and are allowed to build a toolkit that allows them to take a pre-emptive, rather than reactive approach to future liquidity stresses on the fund.

Disclosure

The IA supports the greater inclusion and clearer explanation of LMTs in constitutional documents. In the UK, the fund prospectus includes details of liquidity risk and LMTs that can be used to manage it. However, this would be a good opportunity for managers to review the wording used to ensure that the meaning of liquidity, the meaning and possible impact of liquidity risk and each tool is explained clearly, including how the use of each LMT protects investors.

Significant caution needs to be taken over listing prescriptive scenarios where LMTs would be used beyond a general description of dilution and liquidity risk and how tools are applied and protect investors. A number of unprecedented events, affecting OEFs' liquidity have occurred in recent years, and there is a real danger that a list of scenarios would fail to identify a future event that affects the fund, thereby either constraining the manager's ability to act as it deems most appropriate, or misleading investors. In addition, the disclosure of detailed information runs the risk of allowing more experienced investors to 'game' the fund or bypass anti-dilution measures.

Regulatory reporting

[1] The Investment Association. (2022). *Enhanced Fund Pricing.*

In our comments on Recommendation 1 below, we note that financial stability is an important objective for authorities, who are obliged to collate the appropriate type and amount of data to monitor aspects that can affect financial stability, including liquidity issues and stresses on OEFs. We would like authorities to consider whether fund liquidity reporting should be formalised into regulation, although we advocate reporting requirements, including the frequency of reporting, remain sufficiently flexible to be enhanced at short notice to respond to prevailing market conditions. In addition, authorities should take into consideration the significant resources that reporting can take, particularly where information needs to be collected and complied manually at short notice. Authorities should share and utilise existing data where possible and any additional reporting requests should be utilised only where strictly necessary and limited to essential information.

Comments on the revised FSB policy recommendations

Recommendation 1: Authorities should collect information on the liquidity profile of open-ended funds in their jurisdiction proportionate to the risks they may pose from a financial stability perspective. They should review existing reporting requirements and enhance them as appropriate to ensure that they are adequate, and that required reporting is sufficiently granular and frequent.

We acknowledge that financial stability is an important objective for authorities and authorities are obliged to collate the appropriate type and amount of data to monitor aspects that can affect financial stability, including liquidity issues and stresses on OEFs. Although this recommendation is directed at authorities, we look forward to working with authorities to review who would be the appropriate party to provide the reporting, along with the content of reports. It should also be considered whether fund liquidity reporting should be formalised into regulation, with reporting requirements remaining sufficiently flexible to be enhanced at short notice to respond to prevailing market conditions. This includes flexibility as to the frequency of reporting.

A significant volume of data is already reported by asset managers and other financial intermediaries to both central banks and securities regulators. We acknowledge that authorities have already made efforts to improve data sharing – this is something the industry supports and the sharing and utilisation of data that is already reported, across sectors, should be improved. To facilitate this, the IA along with other buy-side trade associations supports the mandatory use of LEIs and UTIs in reporting at a global level.

Recommendation 2: Authorities should review existing investor disclosure requirements and determine the degree to which additional disclosures should be provided by open-ended funds to investors regarding fund liquidity risk and the availability and use of liquidity management tools, proportionate to the liquidity risks funds may pose from a financial stability perspective. Authorities should enhance existing investor disclosure requirements as appropriate to ensure that the required disclosures are of sufficient quality and frequency. In this regard, IOSCO should review its 2018 recommendations and, as appropriate, enhance them.

The IA wholeheartedly wants to see investor awareness enhanced. In the UK, the risk of dilution and liquidity risks applicable to the fund, along with the availability of LMTs will be included in the prospectus. Where there is an inherent liquidity risk in an OEF, this will also be disclosed in the KIID or KID. However, we are of the opinion that such disclosures should be revisited and enhanced to increase investor understanding on dilution and/or liquidity risks that apply to a particular OEF, the tools that can be employed to manage these risks, how they operate and how they protect investors.

We agree with the additional disclosure items listed.

Managers and authorities should be wary of unanticipated consequences of public disclosure and these disclosures must be carefully balanced to ensure that OEFs do not inadvertently restrict the scenarios where LMTs may be used, or the order in which these can be utilised, or disclose detailed information that could allow more experienced investors to 'game' the fund or bypass anti-dilution or liquidity measures. We agree that a framework/principles-based approach would be appropriate, but managers should not be subject to detailed disclosure rules that could result in restrictions on how managers can use these tools or assist those wanting to game the tools. We would welcome discussion with the authorities regarding the best method of disclosing this information to investors on both an initial and ongoing basis and advocate the use of consumer testing to ensure that any new requirements are fit for purpose and avoid any unintended and undesirable consequences.

Recommendation 3: In order to reduce material structural liquidity mismatches in open-ended funds, authorities should have requirements or guidance on funds' liquidity risk management. Such requirements or guidance should state that funds' investment strategies and the liquidity of their assets should be consistent with the terms and conditions governing fund unit redemptions both at the time of designing a fund and on an ongoing basis. The redemption terms that open-ended funds offer to investors should be based on the liquidity of their asset holdings in normal and stressed market conditions. In this regard, IOSCO should review its 2018 recommendations and, as appropriate, enhance them.

In principle, the IA is in agreement with this recommendation, but as stated earlier in our response, portfolio and asset-level liquidity classification, as described, whilst important, should only be the starting point for determining a fund's liquidity profile, the LMTs to be used and the redemption terms. Other features of the fund are also to be considered, such as the cost dimensions and dynamism of asset liquidity, fund size, market or asset concentration, actual and target investor base, redemption history, liquidation strategy and other funds and accounts managed by the same manager, which may be dealt on in conjunction.

We also think that it would be useful for authorities to 'conduct regular assessments of how managers have classified the funds based on their jurisdiction's liquidity framework and in line with their supervisory approach with a view to promoting consistent classification', using data collected by reporting requirements, as discussed in Recommendation 1.

Assessments would require a consistent framework to be in place; as detailed elsewhere in this response we support a framework, rather than prescriptive rules.

Again, as we detail elsewhere, we oppose the classification of funds into the three buckets. Such perfunctory classification fails to take account of the features of other funds and applies a one-size-fits-all approach to the vast range of OEFs that are on offer globally. It has been seen historically that the liquidity of an asset can change at very short notice in both normal and stressed markets, meaning that funds with a heavy concentration of certain asset types could move between buckets intra-day, which would cause issues at an operational, regulatory and disclosure level. Even with a prudent approach, the liquidity of an asset can deteriorate rapidly.

We also fundamentally disagree with the suggestion 'The relevant authorities could also consider requiring that such (*illiquid*) funds be structured as closed-ended funds.'. The features of a fund, including its structure, should be determined by the manager and these features should be revisited on a regular basis, in line with good product governance practices.

It appears that the debates on dilution management and liquidity management are becoming confused, for example in the statement 'If funds in this category do not meet the expectation on the implementation of anti-dilution LMTs as described in Recommendation 5, funds should consider and use measures to reduce the liquidity offered to fund investors (e.g. by reducing redemption frequency and/or by implementing long notice or settlement periods), as considered appropriate by authorities.'. Effective dilution measures should not have a significant effect on a fund's liquidity and the debate on liquidity management should be taken separately.

Recommendation 4: Authorities should ensure that a broad set of liquidity management tools and measures is available for use by managers of open-ended funds in normal and stressed market conditions as part of robust liquidity management practices. Authorities should also reduce operational and other barriers that prevent the use of such tools and measures. In this regard, IOSCO should review its 2018 recommendations and, as appropriate, enhance them.

The IA fully agrees with this recommendation and its objectives. Managers should manage the fund with the intention of being able to meet redemptions in all reasonably foreseeable market conditions, but they, and authorities should appreciate that there will be occasions where this is not possible and should have all tools available to assist. We have long been advocates of authorities making the entire suite of LMTs available to managers to adopt and utilise in their funds as appropriate on a fund-by-fund basis. We agree that anti-dilution LMTs should be used consistently by and as appropriate for each fund. In particular, fund suspension should remain an option for all OEFs to use when it is deemed to be in investors' best interests and to protect all incoming, outgoing and continuing investors and the fund itself. We recognise that some jurisdictions have further to go than others, but authorities should be encouraged to work at speed to make the full suite of LMTs available for use in a workable manner.

It is important that an LMT framework allows managers to take a pre-emptive, rather than reactive approach to liquidity management and to have LMTs readily available to react quickly, particularly in times of stress. We have seen a number of instances of sudden liquidity stress in recent years where the availability of the right LMTs would have allowed managers to deploy them at an early stage. An example of this would be in relation to Russia's invasion of the Ukraine in 2022 and the subsequent sanctions applied to Russian and Belarusian assets, persons and entities. Operationally workable tools such as side pockets that could have been immediately deployed would have proved an effective way to manage the resulting liquidity issues, had these been available. Authorities moved quickly to allow the required tools to be made available, but even this short delay resulted in zero to minimal take-up.

In relation to the comment 'investor expectations that an OEF will use quantity-based LMTs may add to 'excess' redemptions in times of stress, if investors seek to anticipate potential restrictions on redemptions.', this is the point where we would expect to see 'emergency' liquidity tools, such as side pockets or gates deployed.

We would also encourage authorities to work with managers, distributors and administrators of funds to ensure that any operational or other barriers are identified, addressed and reduced as much as possible.

In the UK, adoption of any LMT by a fund requires the approval of the authority, which is an important safeguard and investors will also be notified where a fund adopts a new LMT. We agree that not all LMTs would be appropriate for all funds and that it is important for authorities to question fund applications for LMTs that they don't think appropriate for specific funds.

Finally, we agree with the statement 'The revised recommendations should determine the expected framework for the use and oversight of LMTs by fund boards, managers' boards or depositories rather than a specific calibration of these tools.'.

Recommendation 5: Authorities should ensure that anti-dilution liquidity management tools are available to managers of open-ended funds. Authorities should also ensure that managers of open-ended funds consider and use such tools to mitigate potential first-mover advantage arising from structural liquidity mismatch in open-ended funds they manage, to ensure that investors bear the costs of liquidity associated with fund redemptions and subscriptions, and to arrive at a more consistent approach to the use of liquidity management tools. Such tools should impose on redeeming and subscribing investors the explicit and implicit costs of redemptions and subscriptions, including any significant market impact of asset sales and purchases to meet those redemptions and subscriptions. In this regard, IOSCO should review its 2018 recommendations and, as appropriate, enhance them as well as to prepare guidance on the design of anti-dilution liquidity management tools.

It is important to emphasise that investor protection is the primary objective of anti-dilution LMTs.

As described above, the IA fully supports the availability of the full suite of LMTs from which managers can select the appropriate LMTs on a fund-by-fund basis.

As regards anti-dilution LMTs, those described are currently available in the UK and are required to be disclosed in a fund's prospectus and the barriers preventing the use of anti-dilution LMTs aren't present.

We appreciate the need for some degree of consistency on the design of and approach to anti-dilution LMTs, but again, we do not advocate too much prescription regarding thresholds, methodology and rates.

Recommendation 6: Authorities should require and/or provide guidance on stress testing at the level of individual open-ended funds to support liquidity risk management to mitigate financial stability risk. The requirements and/or guidance should address the need for stress testing and how it could be done.

We agree with this Recommendation and note that the EU and UK have detailed guidelines in place, provided by ESMA, which came into force in 2020.

Managers should consider employing regular stress testing to examine at what point funds would be unable to fulfil their obligations to investors and ascertain which liquidity tools would be deployed up to the point where the fund would be suspended. Although the methodology of stress testing will be left to the discretion of the manager, a stress testing programme should be based on guidelines, such as ESMA's Liquidity Stress Testing Guidelines for UCITS and AIFs, bearing in mind the Guidelines' principle of proportionality. The frequency of stress testing should be aligned to a fund's liquidity risk profile and testing needs to take account of hypothetical and historical scenarios. There should be appropriate reporting of results, with managers to decide what and how reporting takes place in line with the overall governance framework.

Recommendation 7: Authorities should promote (through regulatory requirements or guidance) clear decision-making processes for open-ended funds' use of quantity-based liquidity management tools and other liquidity management measures, particularly in stressed market conditions. The processes should be made transparent to investors and the relevant authorities. In this regard, IOSCO should review its 2018 recommendations and, as appropriate, enhance them.

The IA broadly agrees with high-level guidance on the use of quantity-based and other LMTs in normal and stressed market conditions, noting the importance of the use of LMTs being at the manager's discretion and ensuring that any guidance is not overly prescriptive.

Recommendation 8: While asset managers have the primary responsibility to consider and use quantity-based liquidity management tools and other liquidity management measures, authorities should provide guidance on their use particularly in stressed market conditions. In this regard, IOSCO should review its 2018 recommendations and, as appropriate, enhance them. Where jurisdictions consider it appropriate, authorities should also provide direction in stressed market conditions regarding open-ended funds' use of such tools and measures, taking into account the costs and benefits of such action from a financial stability perspective.

The IA broadly agrees with the change to Recommendation 8. Such LMTs are important; some, such as reduced redemption frequency and notice periods will be used on a day-to-day basis where these are required. Some, particularly those listed, will be used in times of stress – not just market stress but stress on the fund, e.g. large redemptions. High-level guidance or a framework would be welcomed, but as explained above, more prescriptive rules on the trigger and operation of tools without consideration of the nuances of individual fund profiles will prove problematic.

We also broadly agree with the comment 'This can also assist asset managers in overcoming any reputational or competitive reluctance to use such tools and measures, where appropriate. At the same time, this approach acknowledges that the decision to use such tools and measures should generally remain with the asset manager because the manager is responsible for evaluating what is appropriate for a particular fund…'. However, as mentioned above, detailed disclosures could encourage smarter, more informed investors to game the market.

In a number of jurisdictions, the lack of use of many LMTs is related to the fact that they are unworkable operationally or not permissible. Again, we advocate the need for a full liquidity toolkit to be available, and the rules around LMTs to be structured in each jurisdiction so these offer sufficient flexibility to be made operationally feasible. In this respect, authorities and industry participants should look across other jurisdictions for examples of how particular LMTs have worked in those jurisdictions.

IOSCO and authorities should exercise caution in relation to the proposal 'In exceptional cases, such as when there is a market dislocation or overall market stress or when an asset manager faces operational difficulties in taking appropriate actions, the asset manager may not be best placed to make such determinations. The relevant authorities should, in such cases, consider also providing guidance that is specific to the circumstance concerned to facilitate the application of such tools or measures. Moreover, enhanced regulatory guidance may improve the ability of managers to engage in advance planning regarding the use of quantity-based LMTs and other liquidity management measures in stressed market conditions. In this regard, IOSCO should review its 2018 recommendations and, as appropriate, enhance them. In particular, it could consider establishing standards with respect to how and under what conditions such tools and measures might be used.'. Market stresses and dislocations often happen overnight and in any case before a firm can add a liquidity management tool to its toolkit, bearing in mind internal governance procedures and fund authorisations processes. We agree that authorities should have the power to order a fund's suspension in very exceptional circumstances, but it could be counter-productive to allow that with other LMTs.

Recommendation 9: Where relevant, authorities should give consideration to system-wide stress testing that could potentially capture effects of collective selling by funds and other investors on the resilience of financial markets and the financial system more generally.

The UK is already undertaking system-wide stress testing looking at these issues. Subject to realistic assumptions, based on experience from previous crises and likely behaviours based on the current market structure, we are supportive of efforts to identify and better understand where systemic risk does and does not arise across the financial system.

Responses to questions

Structural liquidity mismatch (Recommendation 3)

Q1. Should "normal" and "stressed" market conditions be further described to facilitate the applicaton of the bucketing approach? If yes, how would you propose describing such conditions?

As detailed above, the IA and our members strongly question the viability and utility of the proposed bucketing approach, but we are not opposed to the use of bucketing as an internal risk management tool to categorise a fund's assets as part of a more tailored approach to establishing individual investment fund's liquidity profiles. This approach would consider all features of a fund, including the cost dimensions of asset liquidity, fund size, market or asset concentration, actual and target investor base, redemption history, liquidation strategy and other funds and accounts managed by the same manager, which may be dealt on in conjunction.

However, 'normal' and 'stressed' market conditions are terms that are used frequently, not least in the case of liquidity management and it may be helpful to have a high-level, consistent definition of each term. Authorities should tread very carefully on what constitutes 'stressed' market conditions as there will be no one right answer for this, rather a realm of indicators that markets are stressed. Managers should be responsible for identifying applicable indicators and then monitoring frequently to detect as early as possible if markets are displaying stressed conditions.

Q2. Are the examples of the factors that should be considered in determining whether assets are liquid, less liquid or illiquid appropriate? Are there other factors which should be considered and, if yes, which ones and why?

Although unsuited for the bucketing approach, the high-level definitions of 'liquid', 'less liquid' and 'illiquid' assets seem sensible. We are cautious about any prescriptive definitions, given the dynamic nature of liquidity in the markets of some asset classes or sub-classes.

Q3. Is the use of specific thresholds an appropriate way to implement the bucketing approach? If yes, are the proposed thresholds for defining funds that invest mainly (i.e. more than 50%) in liquid or less liquid assets and funds that allocate a significant proportion (i.ee. 30% or more) of their assets to illiquid assets appropriate? If not, which thresholds sould be more appropriate and why?

One of the reasons we do not agree with the proposal on the bucketing of funds is that a threshold approach reflects a rigid view of liquidity that is not reflected in the operational reality of the underlying markets and hence the experience of many funds across the market cycle. We therefore do not have a specific quantitative counterproposal.

Q4. Should the FSB consider recommending the use of a decreased redemption frequency (on a standalone basis), a longer notice period (on a standalone basis) or a longer settlement period (on a standalone basis) for OEFs investing in less liquid assets that do not meet the expectation on the implementation of anti-dilution LMTs? Or should these measures be used in combination, considering the risk of redemptions crowding around certain dates?

As detailed above, we support the availability of a full LMT toolkit to minimise the effects of dilution and to manage liquidity. These tools can then be used at the manager's discretion, both on a standalone basis and in conjunction with others, as appropriate. In some cases, for example where a fund's investor base is comprised of a very small number of investors in close contact with the manager, a decreased redemption frequency in isolation may be appropriate. In most other cases, however, the risk of redemption crowding close to a dealing date means that reduced redemption frequency alone would not assist in managing liquidity where the assets held are less liquid. Managers would need to combine this with another LMT, such as notice periods or lengthened settlement periods.

One word of caution, which we will explore more fully in the 2024 consultation on LMTs, is that authorities must ensure that LMTs are fit for purpose when considered from an operational and tax point of view, throughout the entire distribution chain.

Q5. Would additional guidance on factors to consider when setting the redemption frequency or notice or settlement period be helpful? If yes, in what respect?

High-level guidance on factors to consider when applying all types of LMT would be helpful as part of the suggested guidance or framework on fund liquidity management.

Liquidity management tools (Recommendations 4, 5 & 8)

Q6. Do the proposed changes to Recommendations 4 & 5, when read together with the proposed IOSCO guidance on anti-dilution LMTs, help achieve greater use and a more consistent approach to the use of anti-diluation LMTs? If not, what changes should be proposed to the FSB Recommendations?

The IA fully agrees that the availability of LMTs should be widened at a national level, to ensure that the full set, not just a broad set, of LMTs is available to managers to use on a day-to-day basis (i.e. in normal market conditions) and on an exceptional basis (in stressed market conditions). However, stress to funds can occur in circumstances other than a change in market conditions, for example an increase in redemption requests caused by a variety of factors.

We also agree that authorities should work to reduce barriers that prevent the use of these LMTs.

We welcome the removal of the wording from Recommendation 4 'to increase the likelihood that redemptions are met even under stressed market conditions.'. Managers should manage the fund with the intention of being able to meet redemptions in all market conditions, but they, and authorities should appreciate that there will be occasions where this is not possible without, for example, accepting a heavily discounted price for assets or fundamentally changing the nature of the portfolio for remaining investors. In cases such as these, the use of LMTs such as delayed redemptions and suspensions are preferable to meeting a redemption request at all costs.

In relation to Recommendation 5, the addition of a goal of consistent approach in the application of LMTs is welcomed but, as described elsewhere in this response, consistency should take the form of a framework or guidance, rather than overly-prescriptive rules. We would welcome the opportunity to explore this on a tool-by-tool basis.

We make a number of proposals in our response to the IOSCO Consultation Report (see questions 1, 2 and 9) that would shift the focus of Recommendation 5.

Firstly, we propose an alternative objective such that guidance creates an obligation to monitor dilution and, where appropriate, mitigate material dilution. We consider this would ensure better outcomes than requiring managers of OEFs to use an anti-dilution tool, which could lead to the use of poorly implemented or less appropriate tools be regarded as a success.

Secondly, we frame anti-dilution tools as being intended to mitigate investor dilution rather than potential first-mover advantage thereby recognising any reduction in systemic risk due to first-mover advantage is a consequence of effective dilution mitigation not an objective. Finally, we recommend that while the guidance could include a discussion of market impact in the context of estimating implicit costs it should not set expectations about its inclusion. Taking these points together leads us to recommend rephrasing Recommendation 5 as follows:

"Recommendation 5: Authorities should ensure that anti-dilution liquidity management tools are available to managers of open-ended funds. Authorities should also ensure that managers of open-ended funds monitor dilution and, where appropriate, mitigate material investor dilution so as to ensure that subscribing and redeeming investors bear the costs of liquidity associated with fund redemptions and subscriptions, and to arrive at a more consistent approach to the use of liquidity management tools. In this regard, IOSCO

should review its 2018 recommendations and, as appropriate, enhance them as well as to prepare guidance on the design of anti-dilution liquidity management tools."

This approach would also help to resolve the challenge we identify in our cover letter of trying to tie the use of anti-dilution LMTs to specific buckets. The recommendation on anti-dilution LMTs should stand in its own terms – i.e.. a general obligation to monitor the potential for material dilution. It should not be connected to one or more liquidity buckets, as set out on p.15 of the FSB consultation. The latter approach has the potential to confuse measures to address the fair attribution of the cost of liquidity with measures elsewhere in the liquidity management toolkit designed to address challenges that may be arising as a result of underlying market conditions or other stresses on the fund.

Q7. Are there any obstacles (either universal or jurisdiction-specific) to the implementation of the revised FSB Recommendations on the use of anti-dilution LMTs? If yes, what additional recommendations or guidance would help address such obstacles?

The availability and use of anti-dilution LMTs varies between jurisdictions. The IA welcomes the recommendation that all anti-dilution LMTs be made available in all jurisdictions and that there is some level of consistency in the definition and application of these tools. However, differences between jurisdictions as to the structure of OEFs and the way they are distributed should be taken into account to allow flexibility, rather than an overly prescriptive approach.

In the UK, the anti-dilution LMTs described are in general use and have evolved sufficiently to achieve the objectives described.

Q8. Would additional recommendations or guidance be helpful in clarifying the expectation that OEF managers have internal systems, procedures and controls enabling them to use anti-dilution LMTs as part of the OEFs' day-to-day liquidity risk management?

As described above, the IA sees anti-dilution LMTs as an investor protection measure, rather than a pure liquidity risk management tool. We agree that any framework or guidance on anti-dilution LMTs should contain the expectation that OEF managers have internal systems, procedures and controls enabling them to use anti-dilution tools as part of 'normal' procedures.

Q9. Do you agree with applying anti-dilution LMTs to subscribing investors as well as to redeeming investors? If not, why?

Yes. The IA and its members recognise that large deals placed in the market as a result of a high level of subscriptions can generate additional costs in the same way that large deals placed in the market as a result of a high level of redemptions. Such costs should not be borne by existing (in the case of subscriptions) or continuing (in the case of redemptions) investors and any guidance or framework should ensure that such costs (subject to appropriate thresholds) are applied to subscribing or redeeming investors.

Q10. Would additional international guidance on the availability and use of quantity-based LMTs be useful? If yes, what aspects should guidance focus on? If not, why?

Yes, international guidance on all types of LMTs would be useful. Such guidance should recommend that authorities make all types of LMT available for use by OEF managers. In addition, the guidance could focus on a definition of each LMT and disclosure to investors. Such disclosure should include a description of each LMT, how and when they are used and how they can manage liquidity and protect investors. Guidance could consider the experience where LMTs have been successfully used and the rules and guidance established that have allowed them to be feasible. We stress again that guidance should not be overly prescriptive.

Other FSB Recommendations

Q11. Do the proposed changes to Recommendation 2, when read together with the proposed IOSCO guidance on disclosure to investors, help enhance disclosure to investors on the use of anti-dilution LMTs? If not, what changes should be proposed to the FSB Recommendations?

We agree that disclosures relating to LMTs available to a fund should be included. Again, we emphasise that guidance should be within a framework and not be overly prescriptive or require managers to disclose too much information that could enable investors to obtain a first-mover advantage against less knowledgeable investors in the fund.

Recommendation 2 includes examples of disclosing information such as fund liquidity risk profiles which will likely be difficult for a retail audience to understand, particularly the implication that scenario tests need to be disclosed. Ultimately, the key consideration for retail clients is implications of costs, so providing clarity on use of anti-dilution tools and associated potential costs in both normal and stressed market conditions should be the focus, instead of technical details that a retail audience may misunderstand or misinterpret.

Q12. Should any other 2017 FSB Recommendations (Recommendations 1, 6, 7 or 9) be amended to enhance the clarity and specificity of the intended policy outcomes? If yes, which ones and why?

We have commented on those Recommendations individually above, noting that it is more appropriate for authorities to comment.

Additional considerations

Q13. Are there any other aspects that should be considered in the revised FSB Recommendations to ensure that they are effective from a financial stability perspective?

The IA has no other points to raise at this time.