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

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In December 2023, the International Organization of Securities Commissions (IOSCO) published a Report on the anti-dilution tools for liquidity risk management in collective investment schemes.

Previously, in 2021, IOSCO and the Financial Stability Board (FSB) jointly analysed the liquidity risk and its management in open-ended funds (OEFs)1 during the market turbulences due to COVID-19. Both bodies concluded that, although the "dash-for-cash" was one of the main drivers for the redemption of OEFs and for fund managers to decide to sell assets in March 2020, it is difficult to determine the extent to which the potential liquidity mismatch contributed to the market stress. In situations in which an adequate assessment of assets and the use of liquidity management tools (LMTs) are not enough to counter the liquidity mismatch, investors who first redeem their units in the fund can obtain an advantage with regard to those who remain in the fund. In parallel, IOSCO's Assessment Committee carried out in 2022 a thematic review in which it analysed to what extent IOSCO's members were applying measures that took into account the Recommendations of IOSCO regarding liquidity risk management2. In 2022 the FSB performed an assessment of its 2017 Recommendations regarding the financial stability risks arising from the liquidity mismatch3. In its report, this body indicated that there was a substantial variation in the way in which the LMTs were being applied. Moreover, both the FSB and IOSCO observed there was room for greater implementation of the LMTs.

In situations in which investors of OEFs do not bear the liquidity costs associated with the subscriptions or redemptions of the funds, this could harm the remaining investors, which would negatively affect investor protection and financial stability. LMTs can mitigate these effects insofar as the liquidity costs are passed on to the redeeming investors, by means of an adjustment to the price of the transactions. The assessment of the FSB specifically highlighted the need to include the LMTs in the constituent documents of the OEFs (such as prospectuses and offer documents) and the promotion of their use both under normal conditions and in situations of market stress.

Based on the comments received regarding the Consultation Report published on 5 July 2023 and so as to promote the use of LMTs, IOSCO's Final Report provides guidance on the application of LMTs to the entities responsible.

Meanwhile, in December 2023 the FSB published a Report revising its 2017 Recommendations to face the structural vulnerabilities resulting from the liquidity mismatch in OEFs4.

Liquidity management is an essential element for OEFs to operate and to safeguard and protect investors. Generally, these funds offer their investors short-term liquidity (sometimes daily), although the liquidity of the assets invested in varies in the different OEFs and throughout time. When an investor subscribes or requests to redeem an OEF this is performed at the net asset value (NAV) per share or unit. However, the NAV does not always reflect the implicit or explicit costs of the transactions, which can mean that the cost of providing liquidity to redeeming investors could be borne by those investors remaining in the fund, as the value of their units may be diluted by the transaction costs.

This dynamic can affect financial stability when the investors in OEFs who act first have first mover advantage if redemption is requested in advance with the expectation that the investors remaining in the fund bear the transaction costs. This can occur in those OEFs that invest in less liquid assets with short redemption periods, which may cause larger mismatches between the liquidity of the assets and that of the OEFs, particularly during situations of market stress. Although it is difficult to quantify its effect, this behaviour of investors can lead to an increase in redemptions and, consequently, to an increase in the sale of assets to cover such repayments, which can contribute towards higher market volatility and affect the price of the assets.

In order to avoid these liquidity management adjustments in this type of fund, IOSCO's Report includes recommendations on the design and use of LMTs, together with the supervision by the fund managers and custodians, details the information that must be provided to investors regarding the use of these tools and, finally, offers guidance on measures to overcome the barriers or elements that may discourage the use of LMTs.

[1] An OEF is a registered/authorised collective investment schemes that grants its investors redemption rights on their assets, in terms of their net asset value, periodically throughout their useful life, often daily, although this may be less frequently.

[2] FR13/22 Thematic Review on Liquidity Risk Management Recommendations (iosco.org)

[3] Assessment of the Effectiveness of the FSB's 2017 Recommendations on Liquidity Mismatch in Open-Ended Funds

[4] Revised Policy Recommendations to Address Structural Vulnerabilities from Liquidity Mismatch in Open-Ended Funds – Financial Stability Board (fsb.org)

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How to design and use liquidity management tools?

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Guidances 1, 2, 3 and 4 point out that the entities responsible for the management of OEFs are to establish appropriate internal systems, procedures and controls for the design and use of LMTs, determining: (i) the types of LMT; (ii) an appropriate calibration of the liquidity costs; (iii) the LMT activation thresholds; (iv) governance; and (v) the disclosure to investors. Moreover, the entities responsible must be able to prove to the authorities how the aforementioned framework is applied.

IOSCO has identified five from among those tools used to manage liquidity OEFs: i) swing pricing, in which the NAV is adjusted applying a factor reflecting the liquidity cost; ii) valuation at bid or ask prices, where the NAV price is not calculated at its average price but at the bid or ask price, depending on the net fund flows (i.e., whether there are more subscriptions or redemptions); iii) dual pricing[5], in which two NAVs are calculated, one for subscriptions and the other for redemptions, reflecting supply and demand prices; iv) anti-dilution levy, adding or deducting a variable levy to or from the NAV for the benefit of the fund; and v) subscription/redemption fees[6], through which a fixed fee is deducted from the NAV for every subscription or redemption.

Although, in general, LMTs attribute the estimated cost of liquidity to transacting investors adjusting the fund

NAV or the final price received by such investors, their use in OEFs varies regarding their calibration and responsiveness to changing market conditions. When calibrating liquidity costs both the implicit and explicit costs of transaction or subscription and redemption should be considered, including any significant market impact caused by purchase or sale operations regarding such transactions or subscriptions. Since the supply and demand spreads and the market impact cannot be calculated ex ante, it is proposed that the total liquidity cost be calculated as far as possible.

Guidance 4 shows how, in the case that the entities establish a threshold from which the anti-dilution measures will be applied, attempts must be made for this to have a significant impact on the dilution of the fund. For this, factors such as the size of the assets managed and the portfolio characteristics (including the investment strategy and the asset liquidity), estimated cost of liquidity, investor profile and historical fund flows should be taken into account. If the threshold set is too low, it could cause unnecessary costs for both transacting and remaining investors and increase the volatility of the OEF’s NAV. As an alternative, it is proposed the estimated liquidity cost of the assets in which the OEF invests is taken into consideration. For example, in times of market stress and when the estimated liquidity cost exceeds a pre-determined level, the LMT will be activated independently of the total amount of fund flows (subscriptions/redemptions). Finally, it is indicated that threshold for application of the LMT should be subject to ongoing review, taking into account changing market conditions.

[5] Open-ended Fund Liquidity and Risk Management – Good Practices and Issues for Consideration
https://www.iosco.org/library/pubdocs/pdf/IOSCOPD591.pdf pages 22 to 30.

[6] The use of this type of fees for the benefit of the fund to cover the cost of liquidity is more common in the case of redemption. This may be because the fund has an obligation to honour redemption payments within a limited timeframe, whereas the time available for the fund manager to manage portfolio acquisitions to reduce potential dilution from subscriptions is more flexible. However, in the case of a large subscription, which may bring material dilution impact to the fund, anti-dilution LMTs such as a subscription / redemption fee should be used to attribute the cost of liquidity to the transacting investors to protect the interest of remaining investors.

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What LMT governance and supervision should be like?

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A key aspect of LMTs is the governance and supervision by fund managers and custodians. Guidance 5 establishes the guidelines and recommends the creation of an internal governance committee[7] whose members take part in decision-making on the use of LMTs. Its composition should take into account the characteristics and profile of the OEF (investment strategy, investor profile, nature, size and complexity). Said committee would carry out ex ante and ex post reviews on the use and calibration of LMTs on a sufficiently frequent basis, taking into account the redemption periods, while doing so in a documented manner, informing the top management/board of directors of the fund management company. Where an external third party, such as a fund depositary or external auditor, has supervision duties regarding the valuation, pricing and dealing processes, they should also periodically review the processes relating to the use of LMTs.

[7] Depending on the corporate structure, the entities responsible may choose other corporate governance arrangements, for instance, for it to be the board of directors or an existing committee which supervises the liquidity risk management and/or sets the price of the funds.

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How to overcome barriers and disincentives to implementation of anti-dilution LMTs?

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Lastly, the Report offers recommendations to overcome structural or operational barriers, together with negative market perceptions that may discourage the use of LMTs. An appropriate and orderly use of these measures, together with the disclosure of information to investors can contribute to eliminate these obstacles.

Some fund managers consider that the application of LMTs could also have positive effects on the performance of funds, which may actually lead to the standardisation and automation of the processes related to their use. It is also stated that the entities responsible may contribute to their use by educating investors, via closer communication with intermediaries and service providers, such as managers, in the design and application of the measures, while also by means of a continuous review of their application with the aim of informing on possible improvements in their effectiveness. Likewise, regulatory or other obstacles that may hinder the effective use of the measures, can be identified by means of talks between the entities responsible and the supervisory authorities, the aim being to propose solutions to such obstacles.

Links of interest:

FR15/23 Anti-dilution Liquidity Management Tools – Guidance for Effective Implementation of the Recommendations for Liquidity Risk Management for Collective Investment Schemes (iosco.org)

CR03/2023 Anti-dilution Liquidity Management Tools – Guidance for Effective Implementation of the Recommendations for Liquidity Risk Management for Collective Investment Schemes (iosco.org)

FR13/22 Thematic Review on Liquidity Risk Management Recommendations (iosco.org)

Revised Policy Recommendations to Address Structural Vulnerabilities from Liquidity Mismatch in Open-Ended Funds – Financial Stability Board (fsb.org)

Assessment of the Effectiveness of the FSB’s 2017 Recommendations on Liquidity Mismatch in Open-Ended Funds

FR02/2018 Open-ended Fund Liquidity and Risk Management – Good Practices and Issues for Consideration (iosco.org)