ALFI
RESPONSE TO CONSULTATIONS

IOSCO

Revised Recommendations for Liquidity Risk Management for Collective Investment Scheme

alfi association of the luxembourg fund industry

Recommendation 3: Consistency of OEF asset liquidity and redemption terms

Question 1 - Are the identified common components of OEF's structure including notice periods, lock-up periods, settlement periods and redemption caps accurately described? Are there any relevant additional considerations when setting the notice periods, lock-up periods, settlement periods or redemption caps?

As an opening remark, the proposed elements to be included in both the Recommendations and Guidelines are mostly in line with the industry governance practices and considerations. By the same token, ALFI is welcoming and recognising the more nuanced and flexible approach adopted by IOSCO in comparison to earlier discussions on the topic of fund classification.

Against this background, ALFI would also like to underline two main considerations pertaining to the proposed Recommendations 3.

I. Asset bucketing and fund classification

Firstly, it is pivotal to underline the limitations of fund classification and its limited effectiveness in mitigating potential mismatches. A technical review of the described asset bucketing and fund classification approach, proposing to link dealing frequency to a prescriptive assets and fund liquidity classification, highlights the existence of several fundamental factors inhibiting the effectiveness of such method in addressing liquidity mismatches.

While the implementation of the approach is technically feasible, the dynamic nature of liquidity, the inherent model risk and the assets liquidity idiosyncrasies could reduce this tool to a costly regulatory tick-the-box exercise with limited effect on liquidity mismatches and investor protection. Furthermore, a prescriptive approach taken could even set incentives with the unintended consequence of risk underestimation. Some illustrations of these points are provided below.

Model risk – Due to model risk, liquidity estimates used for classification are numerous[1] and inherently noisy. This uncertainty around the liquidity assessment is incompatible with a strict categorical and unequivocal classification of assets that could only be done on the basis of objectively observable and precise criteria. This could also result in significant divergence of classification of similar funds on the basis of alternative models being used.

Time changing liquidity dynamic – Empirical studies and industry experience have highlighted that assets' liquidity profile is time sensitive and fast changing[2]. In addition to asset liquidity, liability liquidity is also subject to natural variations such as increasing fund size or changing investor base. Although the report expostulates and warns against cliff edge effect, the changing nature of liquidity appears either inconsistent with close to static fund arrangements or would

fail to capture the evaporating liquidity and miss the objective of effectively protecting the industry against the same liquidity mismatches.

Incentives and unintended consequences – Classification could incentivize adoption of less conservative liquidity estimates allowing for a more favourable fund classification and more set-up possibilities (dealing frequency and notice period). A principle-based framework focused on the assessment rather than linking classification and dealing terms is less prone to this limitation.

Accordingly, after highlighting the severe shortcomings of a strict classification approach, ALFI recommends to adopt a more principle-based framework, to put more focus on other levers (such as contingency planning) to mitigate liquidity mismatch risk. Against this background, ALFI strongly recommends the link between classification, dealing terms and LMTs to be principle-based and context dependent rather than automatic. This recommendation also considers that categorisation may be deeply ineffective when markets freeze (e.g. Covid 2020). Implementing administrative measures that leave the impression to manage risk when they do not in reality would decrease risk awareness and deteriorate the risk identification and monitoring framework.

II. Exhaustiveness of LMTs proposed

The current proposal lists four LMTs, namely

- Notice periods;
- Lock-up periods;
- Settlement periods; and
- Redemption caps;

Yet the diversity of tools or measures available and with proven track record to effectively protect investors in a wide range of operational set-ups, investment strategies and market conditions is significantly richer. In practice, mismatches are managed with a much broader toolbox allowing managers to face different market conditions as well as adjust to various asset classes and product sophistications. It is worth noting that the list of LMTs is not exhaustive. ALFI is convinced that LMTs should be extensively available across jurisdictions as this would facilitate cross-border activities and be in the best interest of investors. Fund managers should be able to rely on a broad toolkit of LMTs and measures with diverse features and then choose the appropriate ones for the particular circumstances faced, given the nature of the fund, the fund investments and the investors activity on that particular day.

Accordingly, from an economic reasoning and liquidity management perspective the broader set of LMTs and toolkit internally defined and relied upon by the manager is more relevant than the regulatory prescription to choose within a list of predefined tools. For illustration purposes, the list does not include tools such as extension of pre-existing notice periods, gating of redemption and subscription (instead of cap), soft closing, credit facilities under specific

foreseen circumstances and many other tools used to usefully address potential mismatches. Beyond tools, measures have also proven to be very efficient to safely provide daily liquidity to investors. This is for example the case of some distribution models where arrangements are in place and redemption intentions are systematically communicated (e.g. such as a week in advance) before any order is placed. In addition, considering the growing investment opportunities and innovation in fund structuring, a static list would never achieve the objective of being future-proofed and sufficiently flexible to protect investors in a broad spectrum of scenarios.

In this context, ALFI recommends to acknowledge that the list is non-exhaustive and that other tools or measures can be considered equally valid by the Recommendation to adequately protect investors while supporting daily dealing.

III. Other considerations

In addition to the two main considerations, a list of peripheral comments is provided here.

Notice period – While the Recommendation 3 refers to notice period as an LMT, notice period is commonly considered as a dealing arrangement rather than a tool. For example, the Directive (EU) 2024/927 reviewing the AIFM and UCITS Directives mentions extension of notice, rather than notice, in its Annexes (II and IV respectively) devoted to LMTs.

Redemption cap – While the Recommendation 3 refers to redemption cap as an LMTs, in the universe of funds dealt daily, redemption gates are used to a substantially greater extent than redemption cap. Redemption gate is also notably the LMT referred in the Annexes of the AIFM and UCITS Directives review. Furthermore, the distinction is explained in the IOSCO Implementation Guidelines, but Revised Recommendations would benefit from clarification of the difference between redemption cap and redemption gate.

Threshold for gating – The gate should allow for an indicative threshold rather than a binding one. This standard should be valid whether the redemption level is above or below the threshold. Such approach would make activation less predictable but also allow the activation of gating, within the framework of governance, even below the threshold in case this allows to protect investors in specific market conditions, underlying market and/or fund size. More details on this topic are provided in the ALFI response to the proposed IOSCO Guidelines.

Settlement periods definition – The definition provided refers to trade date as follows "*the time between the trade date when a redemption request is made and the date when the transaction of fund units and money are completed and settled*". While the notion of trade date is unambiguous for securities, it is rather undefined in the registrar context. Also, the relevant

time for crystallisation is the redemption date which differs from the date when a redemption request is made. The term 'redemption date' might be more commonly used and understood and we would suggest that this term be used instead of "*the trade date when a redemption request is made*".

Redemption in-kind and in-specie – Redemption in-kind is the wording commonly used in the industry and amongst regulators (see AIFMD and UCITSD review). We are not aware of the difference between the two expressions 'redemption in-kind' and 'redemption in-specie'. Should the Recommendation mean the two terms to carry different meanings, it would be appropriate to define them and highlight the distinctions.

Redemption in-kind and retail investors – The Recommendation highlights that redemption in-kind might not be appropriate for retail investors. Although in practice redemption in-kind is often applied for institutional investor redemptions, the wording suggests to strictly prevent retail investors from benefiting from this arrangement. However, for very specific and standardized assets redemption in-kind can be applicable to retail investors too. A softer wording could provide for this nuance. An overall optionality is beneficial and should not be restricted. In some instances, and for some investors, the use of redemption in-kind might require different parametrisation, but not be prohibited without clear basis.

Category 1 and Anti-dilution tools ('ADT') – Even for the most liquid funds, there are benefits in implementing anti-dilution LMTs as material flows could still result in a dilution. ALFI recommends that the wording in Category 1 under Classification of OEFs be updated to include anti-dilution LMTs

[1] - Fong, K. Y., Holden, C. W., & Trzcinka, C. A. (2017). What are the best liquidity proxies for global research?. *Review of Finance*, 21(4), 1355-1401.

[2] - Nagel, S. (2012). Evaporating liquidity. *The Review of Financial Studies*, 25(7), 2005-2039.
Jiang, G. J., Lo, I., & Verdelhan, A. (2011). Information shocks, liquidity shocks, jumps, and price discovery: Evidence from the US Treasury market. *Journal of Financial and Quantitative Analysis*, 46(2), 527-551.

Recommendation 6: Considering and implementing a broad set of anti-dilution LMTs, quantity-based LMTs and other liquidity management measures

Question 2 - Are there any other key considerations related to the availability and use of antidilution LMTs, quantity-based LMTs and other liquidity management measures under normal and stressed market conditions?

Please refer to the answer to Question 1 and in particular to Section II. on the exhaustiveness of the LMTs and measures proposed. Such a list is bound to be non-exhaustive especially in light of the diversity of investment strategies, funds structures and in a fast-paced innovative environment. Accordingly, it is essential for the Recommendation not to prevent the use of tools and measures outside this list and to acknowledge for the appropriateness of other tools to protect investors and allow for different dealing frequencies including (daily frequency).

Question 3 - Are there any other LMTs or liquidity management measures commonly used by OEF managers?

As mentioned in Question 1 and 2, the list is in essence non-exhaustive and could be complemented with the other tools used as illustration in Question 1. Nevertheless, the list will remain incomplete considering the rich diversity of tools used and the possible specifications of each as well as the development of new tools along with the design of new fund structures. The acknowledgement of this non-exhaustiveness and recognition of the role of other tools is necessary for the Recommendation to foster a wide adoption of the right tool depending on the circumstances and to remain lastingly relevant.

Recommendation 13: Effectively maintaining the liquidity risk management process with adequate and appropriate governance

Question 4 - Have the proposed changes covered all the essential elements regarding liquidity risk management governance arrangements in relation to the use of liquidity management tools and other liquidity management measures? Are they proportionate to the differing size and complexity of responsible entities' fund ranges?

As noted above, the proposed elements to be included in both the Recommendations and Guidelines are mostly in line with the industry governance practices and considerations. Regarding the governance arrangements proposed, ALFI draws attention to four essential elements that would benefit from additional considerations as detailed below.

Principles versus circumstances – The first item of the list of minimum government arrangements, 'objective criteria for making decisions and for the application of LMTs and other liquidity management measures' within the Governance Section, should be clearly differentiated from a requirement to list all circumstances where LMTs can be applied. A requirement to list and/or disclose circumstances/conditions for using LMTs provides the ground for being overly prescriptive and making the governance of activation cumbersome while the objective of the tools is to provide flexibility. There is a risk that the conditions under which the tools are used differ from the prior disclosure/listing. Overly descriptive listing and disclosures could lead to less flexibility and limit the manager's ability to select the most appropriate tools, in terms of

investor best interest, in light of the specific case at hand. It should be possible to still adapt to the specificity of the situations. Given the extraordinary nature of such conditions it would be difficult to provide any exhaustive definition or list prescribing them. A principle-based approach avoids this drawback while still ensuring that LMTs should never be used to encourage or allow investment managers to take undue risks (knowing that there is protection and remedies available). The LMTs toolbox is used in a limited set of circumstances and does not absolve the investment manager of their fiduciary obligation to run the fund in a responsible way in the best interests of shareholders.

To avoid any confusion or interpretation, ALFI recommends that the wording 'objective criteria' could be replaced by 'general conditions' in order to still be illustrative, but not leading to set in stone conditions allowing for flexibility.

Ex-post review does not equate to back-testing – The proposed draft recommends to carry out back-testing as ex-post review. The terminology back-testing carries a very strict statistical meaning. This implies the exact comparison of forecasts or nowcasts with subsequent observable realizations. In practice, some measures, due to lack of observables or low frequency, cannot be subject to such statistical testing but rather to '*controls*' or '*consistency checks*'. Indeed, with regards to LMTs activation, the realizations are often not directly observable. For most quantity-based LMTs there is no obvious observable or counterfactual. For ADT, dilution (costs and impacts) is to be forecasted but actual dilution is not observable and needs to be estimated relying on strong assumptions. In this respect, there is a trade-off between model risk and costs. Either back-testing can be carried out effectively with precise estimates acquired at high costs (such as intra-day data) or back-testing results have limited reliability because of the noise induced by model risk stemming from the assumptions taken (such as taking opening price instead of actual time of the day price). Some industry players are fortunate to have access to quality estimates at reasonable and proportionate costs because of their firm wide operational model (in-house desk, in-house data solution, etc) but this cannot be generalized to all. In this context, the control framework and controls carried out should be designed to strike a balance between the benefits added by the controls and the associated costs ultimately born by the investors. In this sense, fully-fledged back-testing, in the pure statistical sense of the semantic, might not always be proportionate. Furthermore, it is critical to highlight that observed deviations between forecasts (ex-ante) and realizations (ex-post) do not necessarily indicate a parametrization weakness. Such divergences are inherent due to the fact that markets and prices are random variables affected by several other factors and noise. The ex-post review should focus on the identification of systematic, severe and continuing biases resulting from a clearly identifiable pattern and not attributable to noises. In addition, the role of compliance or internal audit of ensuring that the policy approach is reasonable and the methodology is following the policy remains a central tenet of the ex-post review.

ALFI recommends to adhere to the wording 'ex-post reviews' or 'routine checks' and to refrain from mentioning 'back-testing' due to the strict statistical meaning it carries and to allow managers to adopt testing procedures proportionate to a cost-benefit analysis and adapted to the peculiarities, such as the level of sophistication, of the underlying model used.

Role of the depositary – In practice, and in the majority of the existing EU regulatory frameworks, the role and responsibility of the depositary with respect to liquidity and LMTs is clearly scoped and relate to the set up and execution of an appropriate verification plan to check that the manager of a fund has in place documented procedure. Section V of the ESMA Guidelines on Liquidity stress testing in UCITS and AIFS (ESMA34-39-897 EN) perfectly illustrate this defined scope.

The proposed Recommendation significantly extends the role and responsibility of the depositary into the domain of the review and assessment of the appropriateness and adequacy of the procedures with an explicit requirement to reperform ex-post checks. We do not believe the extended scope to be in line with either the existing provisions or industry practices. In addition, while the potential additional costs are clear, the value added in term of investor protection from this extended scope is questionable. In particular, this added requirement could appear to cross-over into the responsibility of the external auditor. Furthermore, the requirements to execute external ex-post check cannot easily be standardised given the variety of tools and models applied by firms which would make this a significant responsibility and ramp up costs. Finally, such requirement should not translate into depositaries, nor for that matter the auditor, dictating the LMTs to use due to market congruencies and commercial pressures as that would cause unintended consequences.

ALFI recommends to align the depositary role with existing regulatory frameworks and keep the depositary responsibilities to the verification that the manager of a fund has documented procedures in place.

Committee as one of the possible structures – In practice, the use of Liquidity Management Committees (different naming convention possible) is widespread, has proven useful in many instances and is an important part of our Investment Oversight. The dedicated paragraph in the Governance Structure Section echoes this observation and underlines the transversal (across functions) capabilities of the committee structure. As such, it is also relevant to highlight that the same objectives can be reached with a different organisational structure than a committee. The adopted structure should both reach the objectives at hand and be appropriate to the operational model of the manager.

Accordingly, ALFI recommends to clearly specify that the establishment of a committee is a frequently adopted and advantageous possibility but does not constitute a strict requirement that would become unnecessarily burdensome in certain operational contexts.

Question 5 - Please describe any material factors of the liquidity risk management governance and oversight arrangements which have not been included.

Please refer to the answer to Question 4, regarding the suggested adjustments to the currently proposed framework to include material factors pertaining to 1) a principle-based framework allowing LMTs to remain relevant in all conditions, 2) a distinction between ex-post review and back-testing to better adapt the accuracy assessment to the type of tools, data and statistical properties, 3) a redefined role of the depositary in line with existing applicable legal framework and 4) a flexible definition of the transversal structure supporting LMTs governance allowing to address various operational frameworks.

Recommendation 17: Disclosures to investors regarding the use of anti-dilution LMTs, quantity-based LMTs and other liquidity management measures

Question 6 - What information can (and should) be disclosed to investors or the public, and within what timeframe should this information be disclosed to enhance transparency when responsible entities activate quantity-based LMTs or other liquidity management measures?

Disclosure to investors and transparency are essential elements of efficient capital markets and investors protection. ALFI supports initiatives allowing investors to gain further knowledge on products and markets when it ensures better protection. More transparency can foster a higher rate of adoption of tools and increase investors' confidence in those tools, and the industry at large. In this context, the notion of transparency focusing on the applicable principles and governance processes framing the implementation of LMTs and aggregated statistics on the use of anti-dilution tools is welcomed.

Ex-post disclosure

In contrast, with respect to ex-post disclosure, full public transparency focusing on the detailed history of tools' activations and on selected parameters (triggers, thresholds, etc) should be avoided.

This Recommendation is stemming from the possibility that some particular investors would exploit public information with detrimental effects on other investors (e.g. the potential for predatory trading and/or herding behaviour by funds and other market participants). Such unintended consequences would arise if investors could anticipate LMTs activations relying on disclosure jointly with other data points or information. The benefits of disclosure are reached with governance focused and principle-based disclosure. The information which could be exploited adversely relates to the detailed application of the tools such as computation methodologies, parametrization and calibration, checks and ex-post activation data. Accordingly, the nature of the disclosed information is more relevant than the quantity. The last paragraph of Section 'Disclosure about the use of anti-dilution LMTs' of the Recommendation

16 directly refers to this threat. The same potential unintended consequences exist in the case of ex-post disclosures for some quantity-based tools.

Recommendation 16 suggests to rely on delayed and/or ex-post disclosures to mitigate the negative side effect of transparency. However, such twists do not fully alleviate the concerns. Indeed, the LMTs parameters are rather stable as they are calibrated on fundamental financial economic factors. This stability implies that past data, even if delayed, can be used to forecast LMTs activation behaviour and calibration. The frequency needed to reach safe disclosure is excessive in comparison to financial market dynamics. Similarly, in order not to feed front-runners predictions the range of thresholds would need to be excessively broad to the point of not fitting the purpose of transparency.

It is also important to highlight that costs disclosures remain essential for investors. In Europe, the joint efforts of regulators and the industry in establishing the PRIIPS framework provide for this transparency need.

In order to strike a balance, ALFI recommends public disclosure to be made at the level of applicable principles and governance arrangements but to restrict other information regarding specific parameters and past activations to supervisor's disclosure only. For supervision purposes, with considerations to the proportionality between costs and benefits, as is already the case in Luxembourg with the semi-annual UCITS Risk Reporting established and used by the Commission de Surveillance du Secteur Financier ('CSSF'), more transparency on the past activations of anti-dilution tools could be provided to National Competent Authorities. For example, in term of market wide disclosure, the CSSF makes publicly available information on the aggregated past uses of liquidity management tools in their periodic UCITS Risk Reporting dashboard.

Ex-ante disclosure

Regarding ex-ante disclosure, two provisions introduced by the Recommendation appear to exceed and go beyond what constitutes a principle-based approach.

Firstly, the Section 'Disclosure of liquidity risks' indirectly refers to the disclosure of circumstances triggering LMTs activation in the offering document by stating:
"*This should include an explanation as to why and in which circumstances it might crystallise (for example, in case of severe market dislocations); its significance and potential impact on the CIS and its unit-holders, and a summary of the process by which the responsible entity aims to mitigate the risk.*"
Repeating the argument outlined above regarding principles versus circumstances, the enumeration of circumstances should not be overly prescriptive otherwise this could prevent the activation of adequate LMTs in unforeseen and/or unprecedented circumstances.

To preserve this ability, ALFI recommends that the wording 'circumstances' could be replaced by 'general conditions' in order to still be illustrative, but not leading to set-in stone conditions allowing for flexibility. For instances, some examples could be included but the use and activation of LMTs should not be limited to those illustrative situations. This should not prohibit the use of the tools in relevant unforeseen situations but which have not been contemplated or crystallised to date.

Secondly, the Section 'Disclosure about the use of anti-dilution LMTs' establishes the requirement to "*set out details of the constituents of the costs taken into account to calculate the adjustment factor, including the calculation or estimation basis*". A detailed disclosure has two shortcomings to be considered. A granular breakdown could provide sophisticated investors with more information which, when aggregated with other public data, could increase the predictability of LMTs applications and parameters. In addition, a disclosure to investors of constituents could turn into a horserace between incomparable funds with fundamentally diverging characteristics, models and data.
ALFI therefore consistently recommends the disclosure of general principles pertaining to the constituents of the adjustment factor rather than an exhaustive and detailed list.

Recommendation 17: Other Proposed Revised Liquidity Recommendations

Question 7 - Do you have any comments on any of the other Proposed Revised Liquidity Recommendations put forth in this document?

Despite the fact that the consultation is not directly targeting the update of Recommendation 7, it is valuable and constructive to recall the consequences of the requirement to impose on subscribing and redeeming investors the explicit and implicit costs of subscriptions and redemptions, including **any** significant market impact of asset sales to meet those redemptions.

The virtue and economic sense of including market impact in the total cost passed to transacting investors is fully acknowledged. Nevertheless, in practice, one should recognize that significant market impact a) is not directly observable and b) has to be forecast to account for different incoming transaction features (e.g. market conditions, size, timing, etc).

Therefore, significant market impact measures are only proxies and need to be estimated. Estimates are (usually) generated by models and inherit the limitations and uncertainty from the selected model (same dynamic as introduced in Question 1 in the model risk paragraph). A broad spectrum of market impact models exists relying on different sets of assumptions and data. These range from sophisticated models based on high frequency data to more elementary approaches driven by (conditional) descriptive statistics. In a comprehensive review, Fong, Holden and Trzcinka (2017) provide empirical evidence on the performances, similarities and

divergences of the estimates generated by alternative liquidity models encompassing both high and low frequency data-based forecasts.

In this respect, there is a trade-off between model risk and costs. On the one hand, some standard models can generate estimates at reasonable costs but with a sizeable uncertainty around these estimates and therefore around the cost to be passed on to transacting investors. On the other hand, other, more sophisticated, models can generate precise estimates and forecasts but at more substantial costs and data requirements.

The benefits of the inclusion of significant market impact into anti-dilution tools should not be outweighed by the associated downsides in term of uncertainty impacting the fund net asset value and costs ultimately borne by investors. The decision to include market impact into anti-dilution tools should therefore result from an assessment of whether market impact can be estimated adequately and at a fair cost to investors. The conclusion of this assessment would diverge depending on the set-up and pre-existing resources of each manager.

ALFI recommends that the decision to include market impact into anti-dilution tools would remain the ultimate responsibility of the manager on the basis of a cost-benefit analysis rather than an external regulatory prescription.

Fong, K. Y., Holden, C. W., & Trzcinka, C. A. (2017). What are the best liquidity proxies for global research?. *Review of Finance*, 21(4), 1355-1401.