alfi association of the luxembourg fund industry

The Association of the Luxembourg Fund Industry (ALFI) represents the face and voice of the Luxembourg asset management and investment fund community. The Association is committed to the development of the Luxembourg fund industry by striving to create new business opportunities, and through the exchange of information and knowledge.

Created in 1988, the Association today represents over 1,500 Luxembourg domiciled investment funds, asset management companies and a wide range of business that serve the sector. These include depositary banks, fund administrators, transfer agents, distributors, legal firms, consultants, tax advisory firms, auditors and accountants, specialised IT and communication companies. Luxembourg is the largest fund domicile in Europe and a worldwide leader in cross-border distribution of funds. Luxembourg domiciled investment funds are distributed in more than 70 countries around the world.

We thank IOSCO for the opportunity to participate to the present consultation report in respect of Anti-dilution Liquidity Management Tools – Guidance for Effective Implementation of the Recommendations for Liquidity Risk Management for Collective Investment Scheme.

ALFI wants to highlight the ongoing review of the AIFMD and the new liquidity risk management related provisions (e.g. new article 18.a (Amendments to AIFMD and UCITSD)) that also aim to ensure that a larger set of Liquidity Management Tools (LMT) are available to UCITS and AIFs and that the inclusion of any given LMT is part of a wider assessment by the responsible entity.

We would also like to point out to IOSCO that ALFI is responding to the FSB consultation on addressing structural vulnerabilities from liquidity mismatch in open-ended funds – revisions to the FSB's 2017 policy recommendations.

ALFI will outline in response to the IOSCO consultation report, among others, the following main considerations:

1. ALFI generally supports the IOSCO consultation, its aims of greater availability and greater uptake of a broad range of liquidity management tools and its guidance in open-ended mutual funds.
2. ALFI wants to highlight that not all deals in a stressed market conditions are First Mover Advantage related – e.g. there were significant asset allocator movements in March/April 2020.
3. Some responsible entities may be large and very sophisticated, but not all entities will have developed practices in this respect to the same level. ALFI would like to suggest that IOSCO guidelines need to accommodate all ends of the spectrum.
4. ALFI would like to highlight that anti-dilution mechanisms are primarily business as usual (BAU) tools to protect long term investors, rather than a liquidity management tool.
5. Definitions such as "normal markets", "stressed markets", "significant" and "material" should be left to each responsible entity to define for their business.
6. Responsible entities are best placed to define appropriate anti-dilution / liquidity management techniques appropriate for their business and the circumstances on when and how to use them.
7. ALFI wants to stress that some managers may not yet have implemented anti-dilution LMTs as BAU/standard or some may only be in the early stages of doing so.
8. ALFI believes that it is paramount to retain proportionality and flexibility. Particularly the ability to react quickly when markets become stressed.
9. Cost / benefit criteria should be considered by responsible entities when deciding on the appropriate anti-dilution levy / liquidity management tool to apply to their business.

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Proposed Guidance 1 – Overall Framework

1. To what extent does the proposed guidance 1 help responsible entities to better integrate the use of anti-dilution LMTs within their existing liquidity risk management framework? Have all the critical elements been captured?

ALFI agrees with the general sentiment of the proposed Guidance 1. In general, we note that the guidance looking at Liquidity Management Tools is acceptable, we would like to point out however that in reality in stressed situations responsible entities would look at additional options that could be used in parallel, such as, but not limited to:

- Valuation - leveraging options such as fair valuation or incorporation of traded security prices on the trade date in the NAV, and
- Wider prospectus powers – considering the use of powers laid down in the relevant prospectuses of the responsible entities such as "consideration of subscription refusal", definition of business days, redemptions over 10% of net assets, deferral of cash proceeds.

The section on valuation could be further enhanced by adding further explanations. This is an entire topic in itself. The example of stale valuations is too simplistic and might be misunderstood. One should also consider the effects of events that happen in the global business day where markets in the east have closed and for which closing prices are established. If a significant market event happens post close then the opening market valuations the next day are likely to be out of sync with the closing market values from the previous day. In such circumstances the application of security level and market level fair valuation methodologies is important to negate the impacts mentioned in the guidance.

2. Do you agree with the proposed guidance 1 regarding the inclusion of anti-dilution LMTs within the daily liquidity risk management framework that OEF managers should have in place at all times?

ALFI believes that appropriate anti-dilution liquidity management tools ("AD LMT" or "anti-dilution LMT") should be available at all times and be capable of being used on a daily basis in business as usual as well as in stressed market conditions but only implemented where appropriate/needed.
Anti-dilution LMTs are appropriate from an investor protection point of view, irrespective of any systemic risk considerations.
As outlined in our response to Question 3, ALFI would like to highlight that anti-dilution LMTs are not needed or appropriate for all type of funds necessarily.

Alternative Investment Funds, including among others asset classes such as real estate, private equity and infrastructure funds, need differentiated considerations.

ALFI would like to outline that the consultation does not make any differentiation between requirements for traditional daily traded liquid funds and other typically real assets / alternatives structures such as open-ended Real Estate ("RE") funds that are usually traded less frequently, with a predominately professional (well-informed) investor base.

The Report does not consider that (most) RE funds:

a. operate with a commitment mechanism and as such draws the capital from investors only once a suitable investment has been found or when needed for liquidity purposes;
b. pay redemptions firstly with undrawn commitments and unencumbered cash or will facilitate a secondary trade and as such will sell properties as a last resort;
c. may already use an adjusted NAV such as adopting INREV (European Association for Investors in Non-listed Real Estate Vehicles) adjustments for amortising acquisition costs and the potential savings associated with selling assets in a tax efficient manner (deferred tax liability adjustments), which are adequately disclosed in the OEF's constitutional documents;
d. most RE funds have a redemption mechanism which allows for lengthy settlement periods (not uncommon to see settlement periods of at least 12 months) and the redeeming investor is paid on the latest NAV as opposed to the NAV at the time of the redemption request);

Accordingly, such funds already have more appropriate mechanisms in place and which would not be improved upon by the anti-dilution liquidity management tools outlined in the consultation.

We would like to point out that the ALFI Luxembourg Real Estate Investment Funds Survey 2021[1] ("Survey") outlined that only 1% of Luxembourg Real Estate funds (of those who answered the survey, but over 2/3 of the Luxembourg population) made use of their liquidity management tools over the COVID 19 pandemic (page 4 of the Survey). The survey indicates that existing prospectus powers and tools are already sufficient for Luxembourg REIF.

We would like to outline that current market data for open ended real estate funds is scarce (and thus does not appear to have been taken into consideration of this consultation). Liquidity assumptions by "responsible entities" are based on estimates and a large degree of subjectivity which will mean that calibration factors will vary greatly (even for comparable funds).

ALFI would like to stress the particularly subjective nature of estimating, in particular, implicit costs for RE assets. Historical crises (stresses) have demonstrated very different impacts (and speed of those impacts) on real estate markets and it would not be appropriate to limit a fund's investment decision based on historical stress test results but rather use these as a basis for further analysis to determine the most appropriate liquidity management technique response.

3. Is this proposed guidance appropriate for all types of OEFs in its scope, and proportionate for all types of responsible entities to implement? If not, please explain.

As outlined in response to question 2 above, ALFI does not believe that anti-dilution LMTs are needed for all types of funds. There are vehicles, product structures or situations that do not require anti-dilution protection

- Funds of One (i.e. typically where one corporate investor is the sole shareholder) may not need any dilution protection.
- Funds of funds may have dilution protection at the feeder level rather than the master.
- Very liquid funds where any dilution is likely to be very low e.g. 1-3 basis points – and where, for example, an anti-dilution of that magnitude would not move the NAV per share price.
- If there is no shareholder dealing.

[1] https://www.alfi.lu/getattachment/5b68ccfe-ae7e-4f25-9fe4-41f257b6f9b8/app_data-import-alfi-luxembourg-real-estate-investment-funds-survey-2021.pdf

- Fund structures where delayed valuation and shareholder dealing cycles facilitate actual security trade prices to be incorporated into the dealing nav per share.
- Open ended funds with some exposure to more illiquid asset classes such as an ELTIF or Real Estate product will have more appropriate solutions built into their product structures which are unlikely to be enhanced by additional liquidity management techniques.
- Funds with perhaps several third-party investment fund managers mandated to several funds would experience additional complex challenges

Proportionality

- The responsible entity should undertake and evidence a prior cost / benefit consideration for the type and frequency of LMT selected.
- For certain asset classes/ investment structures there are other more appropriate solutions, such as:
    - funds that always hold more illiquid asset like Real Estate will via product structure extend shareholder prior notification, dealing and settlement cycles;
    - similarly, ELTIFs where asset classes may be partly / purposefully more illiquid would have similar product level solutions.

  In summary, if a shareholder dealing is closely controlled or if there is no shareholder dealing, then there is no dilution requiring anti-dilution LMT and therefore no potential first mover advantage.
- Exceptions should be allowed, but there would need to be a full/robust justification by the responsible entity or its delegate(s), as appropriate.

Proposed Guidance 2 – Types of Anti-Dilution LMTs

4. Has the proposed guidance identified all of the anti-dilution LMTs commonly used by responsible entities? Are there any other LMTs that share the same economic objective of passing on the liquidity cost to transacting investors, that could be included in this guidance? If so, please describe them.

The description of the 4th anti-dilution LMT mentioned ‘anti-dilution levy’ could be expanded to also encompass single priced funds where the anti-dilution levy reflects the bid/ask spread.

In addition, this could be better described as:

> *“increasing the final amount (rather than price) paid by subscribing investors or decreasing the proceeds (rather than price) received by redeeming investors, […]”*

ALFI agrees that the objective is to mitigate dilution, not to entirely remove it.

A sixth LMT could be considered being valuation at “mid or bid or offer” which is then adjusted by costs of liquidity/market impact but doesn’t flip around in the way that ‘valuation at bid or ask prices’ (page 12) would.

The guidance technically does not explicitly cover dual priced funds with spread or crossing or spread AND crossing.

5. Are the identified anti-dilution LMTs described correctly? Do the features or characteristics of the different tools vary or do they generally operate as described?

As outlined under response to question 4 above, ALFI believes that the guidance does not explicitly consider dual priced funds with spread or crossing or spread AND crossing.

6. Do you support the proposed guidance 2? If not, in which cases do you think it could be justified not to adopt at least one anti-dilution LMT in OEFs (other than ETFs and MMFs)? What elements do you take into consideration to choose a specific anti-dilution LMT for your OEFs ?

ALFI believes that the wording in respect of Guidance 2 could more clearly highlight that one or more anti-dilution LMTs can be used and that different tools may be better in different specific events / circumstances. It would in addition be suggested that responsible entities should have the ability to use the most appropriate anti-dilution LMTs for a specific situation.

In addition, we would like to remind, as outlined above under response to question 2, that not every fund will require or benefit from such LMT, such as for funds of one, feeder funds or fund of funds or where dilution is non-existent and some alternative funds.

Furthermore, where other valuation or prospectus power solutions are available and used, then there might not be a requirement for LMTs.

In the context of which specific LMT to select, we would like to outline the following considerations:

- Can estimated net cash flows be robustly determined, in time and in a format that can, in the available timeframe, be robustly consumed by operational processes. If not, an anti-dilution LMT that does not require this would be better suited.
- Operational capacity to move valuation from bid to mid to offer depending on flows.
- Volume of dealing – funds with high subscriber/ redeemer dealing volumes may want to consider an AD LMT that is at fund level (e.g. swing pricing) rather than a tool that is at deal level (e.g. subscription/ redemption fees).
- Consideration of the fund client base:
  - e.g. is the fund primarily marketed in countries where certain anti-dilution LMTs are not currently used or has the target client base indicated a preference for a particular type of anti-dilution LMT.
  - if the fund is made available to retail investors via a Distributor then the overall operational structure is relevant i.e. fund level anti-dilution levy LMT (like swing pricing) will be preferred over individual beneficial owner level anti-dilution levy LMT (subscription / redemption fees).
- When assessing the use of anti-dilution LMTs, we recommend that the Operating characteristics are fully considered e.g. the fund administrator / transfer agent / distributor / broker dealer be consulted to understand and contribute to the operating model design.

Alternative Investment Funds, including real estate funds need differentiated considerations.

The two anti-dilution LMTs that can be seen as appropriate for RE funds (and that are included in the list) are anti-dilution levy and redemption fees. For illiquid investments, such as RE, it is difficult to determine an appropriate anti-dilution levy or redemption fee, especially when the Report (and

regulators) requires implicit costs to be considered. The European real estate investment community, through other associations such as INREV, has already largely addressed anti-dilution LMTs and we believe there is no need for prescriptive measures to be introduced.

Lastly, the proposal assumes that a fund would have to transact properties in order to satisfy redemptions, whereas in reality it is likely to be the last resort option (utilising undrawn investor commitments, unencumbered cash and facilitating secondary trades are likely favored options).

Proposed Guidance 3 – Calibration of Liquidity Costs

7. Have the components of the cost of liquidity, as described above, captured all the relevant costs that should be considered when calibrating anti-dilution LMTs?

Explicit Transaction Costs

- Broker commissions paid by the fund on an actual or historical basis;
- Custody transaction charges on an actual or historical basis;
- Fiscal charges (e.g. stamp duty, sales tax, transactions tax either on the security or on the currency required to purchase the security), any initial charges or exit fees applied to trades in underlying investment funds, where applicable;
- Share class specific items, e.g. if there is a notable cost specific to one particular class. Foreign Exchange costs could be included where significant e.g. hedge share classes.
- Any swing factors, dilution amounts or spreads applied to underlying investment funds or derivative instruments.
- Passive vs active investment: there may be little or no price impact for security trading in respect of certain passive investing funds, particularly those using synthetic replication.
- Bid/offer/mid pricing AD LMT could still need something like spreads incorporated to account for items like broker commission, stamp duties and taxes.

Implicit Transaction Costs

Depending upon the fund structure the bid/ask spread, particularly any consideration of market impact, will not be known at the time the fund is valued and these would therefore be estimated in advance.

Alternatives Funds will have additional / different characteristics

For Real Estate funds, the “explicit” costs will vary depending on location (e.g., notary fees are different in each country) but is possible to estimate with reliable data.
For “implicit” costs, which are driven by demand, it will depend on the quality of the property and market conditions. Due to the lack of market data, it is hard to estimate the “implicit” cost accurately and given it is based on a lot of subjectivity, there is a risk that there is a wide difference in the calibration for similar funds. This will inevitably lead to higher costs chargeable to the funds as managers instruct professional advisors to assist in demonstrating the fair treatment of investors in the process.

Significant Market Impact

The following statement "*an assessment (e.g., slippage assessment) is needed before the sale / purchase is made, taking into account the size of the transaction, asset class, market structure and the prevailing market conditions […]*" Yes slippage can act as a proxy for market impact but these are different calculations.

- Slippage is the difference in cost from the cost at time of the decision to place the trade to the cost of the actual trade achieved.
- Market impact is the difference in price in the fund valuation at which subscriptions/redemption are transacted to that actually achieved via security purchase/ sale.

Instead this could be referred to as a 'dilution assessment'

ALFI agrees that liquidity costs should be measured as the cost estimate to be incurred by the fund to buy or sell a pro rata slice of the fund, even though, as the consultation notes, a fund may not transact in a pro rata manner. We choose the word estimate because realistically this is an estimate – considering for example costs in different asset classes or sub asset classes, but not security by security.
In addition, we do not believe that the assessment of market impact should be mandatorily required. While ALFI understands why this could be desirable, we do not believe it can be readily measured or modelled, particularly for fixed income securities, where a number of factors that may move in different directions or magnitudes (and cannot be disaggregated) may play a role in price slippage: such as spread widening, liquidity premium based on trade size, secular market sentiment.
If we are unable to disaggregate these components, there is no robust mechanism to quantify and predict their behaviour going forward.

There should be no caps or restrictions that prevent anti-dilution LMTs from incorporating all costs – prospectus driven caps on swing factors are required for normal conditions but able to be extended in exceptional circumstances – with appropriate disclosure)

Subscription / redemption fees should not be calculated 'conservatively' a suggested in the consultation but should be calculated as accurately as possible and changed as required

8. How does the cost of liquidity vary across different funds? To what extent could we achieve a more consistent approach to calibrating anti-dilution LMTs for similar funds, and what is the best way to do so?

Cost of Liquidity

ALFI wants to highlight the very difficult nature to have a homogenous approach to cost of liquidity across similar funds. There might be ways to create more common methodologies of calculating cost of liquidity by asset class but beyond that (e.g. universally consistent factors of adjustment by asset class) it would seem improbable as there are many controllable and uncontrollable variables – for example

- The cost of liquidity will vary depending on the type and liquidity of securities in which the fund invests – cost of liquidity for highly liquid securities can be expected to be lower than that of less liquid securities;

- It will depend on commercial agreements that the responsible entities have with trading venues and brokerage houses and variable practices and costs structures across trading venues, markets and geographies;
- It may also vary depending on the costs, and hence the dilution impact, associated with the markets / jurisdictions in which a fund invests;
- It may also be impacted by fiscal charges (e.g. stamp duty, sales tax, transactions tax either on the security or on the currency required to purchase the security), any initial charges or exit fees applied to trades in underlying investment funds, where applicable;
- Index funds with a passive investment style and very large number of holdings (or using synthetic replication) could facilitate significant subscription/ redemption activity without incurring significant market impact. By contrast Active funds with a more focussed investment style could be more likely to incur significant market impact;
- The cost of liquidity can vary due to market sentiment, government activity or broker sentiment.

In addition, we want to outline that "explicit costs" may vary instrument by instrument: for equities and futures, brokers collect a pre-determined execution commission; while fixed income commissions are incorporated into the final trade price – and can vary with market conditions. This is similarly true of implicit costs such as bid-ask spreads and market impact, which can also be influenced by the size of the order being generated.

Consistent approach

- Given diverse fund structures, operating models and regulatory environments a flexible and principles-based approach would best achieve such aim;
- A dialogue and sharing of best practice could assist a more consistent approach to calibration;
- However, whilst we can look for greater consistency in approach, whilst retaining sufficient flexibility, achieving greater consistency in outcome will likely prove elusive, as
    - different asset managers will have different trading teams, different trading terms and achieve different results.
    - different fund structures e.g. passive v active and types of investment holdings will derive different results.
    - calibration is in any case on an estimates basis.

- The main differences between different LMTs e.g. swing pricing, anti-dilution levy, redemptions / subscription fees and spreads is generally where and how these are applied – not how they are calculated.

Alternative Investment Funds, as outlined under Q2 above, need differentiated considerations.

An additional characteristic for Real Estate as an example of an Alternatives Fund is there is also the subjectivity of choice of asset for disposal, for example choice of an asset in a specific country with a higher / lower cost of sale, which may lead to disputes with redeeming or remaining investors depending on the effect of sale costs on the NAV at redemption.

9. How can significant market impact be incorporated in the calibration of all of the proposed anti-dilution tools? Please provide examples.

ALFI believes that this must be left to the discretion of the responsible entity.

In general, "market impact" should as far as possible for those more sophisticated asset managers be estimated for normal market conditions but with processes to amend this quickly should stressed market conditions apply.

- When considering how to estimate market impact, a close liaison with the traders executing portfolio management decisions will be required.
- It could be that implementation shortfall (sometimes called slippage) is already estimated. Implementation shortfall is the difference between the price at the time of a decision to buy or sell a security and the final
price achieved after all execution costs. It therefore includes market movement between the time of the trading decision and order
- Alternatively, it could be that the trading department of the investment manager has information of a level of sophistication that could estimate, based on previous activity, the probable price impact upon individual securities and thereby funds, dependent upon different flow levels, and this information could yield a considered understanding of market impact.
- Use of Third-Party vendors may assist with certain data sources.
- In estimating market impact, it is preferable to have processes that estimate the cost of buying or selling a complete slice of the portfolio rather than only focusing on the actual trading that may have taken place in a period.
- In the event that trading is automated then consideration should be given to extraction of the necessary data for these purposes when the system is being designed.
- More than one data source may be required to arrive at a reliable estimate which should regularly be back-tested for accuracy.

For pricing at bid/ask, an estimate of market impact can be added into the spread and thereby reflected in the security price at valuation point.

Retail fund structures requiring the nav to be issued on Trade date will have to estimate market impact.
Certain institutional funds with a different (delayed) dealing/ valuation cycle could include actual security prices achieved.

With respect to market impact, ALFI would like to outline that different responsible entities have different capabilities with respect to the availability of data they have at their disposal. Many firms do not presently have the depth of data required to build their own proprietary solution for market impact costs. Other firms may not all have the data centralized to be able to achieve this due to legacy structures and acquisition strategies over the years. Implementing LMTs in the first place might have a material impact for a significant part of the industry, and so enforcing or promoting the need to include market impact seems that it might be a material impact for some providers and their ability to have accurate outputs. The confidence in the end result may be significantly reduced. We would like to avoid regulation mandating that this must be implemented and having firms implement it in an ineffective manner that would question the efficacy of the approach. Therefore, responsible entities should have the ability to use their discretion in whether they would like or have the ability to apply the market impact component or not but there should be appropriate transparency to investors in this respect.

More investigation on market impact components is required. Competent authorities should not implement rules around the use of LMTs using market impact that could bring into question the legitimacy of the practice due to an inability to apply it effectively. There needs to be a high degree of confidence in the practice and the values being incorporated. Data would use historic experience, but recent events have been relatively unprecedented which then would raise questions around the appropriateness of / the experience of the data we should rely on and the value to be applied. We need to be absolutely confident before implementing methods that investors might interpret as a mechanism to prevent them redeeming their investments from the product – this might lead to unintended consequences and lessen the attractiveness of investment funds to investors.
Separately, implementing this would mean more costs to the funds and therefore to investors. One has to wonder whether in all cases the benefits would outweigh the costs and whether this was the intent of the exercise/consultation.

10. Can all of the components of the cost of liquidity (i.e., explicit and implicit transaction costs including any significant market impact) be incorporated in all five anti-dilution LMTs as set out in the discussion of Element (i) above? If not, what are the limitations to doing so and how would you suggest improving the effectiveness of these anti-dilution LMTs?

ALFI believes that any particular cost of liquidity LMT adopted will depend on the asset managers' operational framework and the degree to which the asset manager could accurately calculate or estimate it. Even explicit costs will have to be estimated in certain operational processes and an overall perspective would have to be arrived at as to which techniques may or may not be practicable.

- Swing pricing- yes but "market impact" must be estimated in advance.
- Valuation at bid or ask prices – bid & ask do not necessarily include market impact but this could be added in.
- Dual pricing - does not include market impact but this could be added in.
- Anti-dilution levy – yes but would not work for intermediated distribution.
- Subscription/ redemption fees – yes but it would be necessary to estimate market impact in advance.

However, we believe that the responsible entity should have discretion concerning market impact with appropriate evidence and perhaps a level of transparency, as opposed to market impact being always required in some form or another.

Not all asset managers may have the current capability to include market impact (e.g. access to data, or the experience/expertise to apply it) however not all fund types /situations would require/ benefit from the inclusion of market impact or the use of other options such as Valuation or Prospectus powers may be provide satisfactory outcomes via different means.

For those smaller managers that do not have access to data, it may not be cost-effective to buy in a market impact solution as ultimately those costs would be passed on to the end client.

At the very least, prior cost/ benefit should be considered and exceptions should be allowed but there would need to be a full/robust justification by the Responsible entity or its delegate(s).

11. To what extent can a subscription / redemption fee achieve the objective of addressing the investor dilution issue and financial stability concern of OEFs by attributing the liquidity costs to transacting investors? How could it be appropriately calibrated to achieve this objective?

In general, ALFI believes that the primary reason must be that of "shareholder protection" as an anti-dilution tool. There can be consistent approaches to calculation of the appropriate anti-dilution levy LMT – the difference can be in how they are applied – so whilst conceptually a subscription / redemption fee could be successful in achieving such an objective, we want to outline the following:

- Concerning calibration: the frequency of change / responsiveness to changing market conditions would be important.
- Where such a fee is charged may also be relevant – if it is charged at the broker dealer then there could be a high volume of entities with which to coordinate, making it potentially challenging to change quickly/ frequently or requiring automation/ communications to achieve this and also a high volume could result in challenging cash reconciliations. If the charge is made at the Transfer Agent then such challenges are mitigated.
- Also such a fee would be charged gross on subscriptions and redemptions, whereas the portfolio manager deals on net flows.

12. Do you see benefits in a tiered approach to attributing the cost of liquidity by using different adjustment factors according to net fund flow, market conditions and characteristics of the funds? Are there any operational difficulties? Any further comments thereto?

ALFI wants to outline that there are two schools of thought around tiered models.

On one hand certain ALFI members see the additional benefits to a tiered approach. The aim of multiple thresholds is to have more representative swinging. Funds will swing more often, but on average by less. The NAV variation and impact on fund performance is therefore less marked. Thresholds can commence lower in tiered models thereby capturing more dilution.

The swing factor for the highest threshold triggered on a day is applied to the whole fund.
There are further advantages of multiple thresholds:

- they are more reflective of the trading curve, with each threshold triggering a different swing factor in order to take account of differences between overall costs and dilution on small security deals (typically with low spreads) and very large deals (typically with much larger spreads and where market impact can occur).
- They can also reduce the opportunity for investors to attempt to arbitrage the swing pricing process.

Conversely, multiple thresholds add additional complexity for shareholders to understand, can be operationally complex to apply and consequently involve higher risk.

Consideration should therefore be given to the level of automation and/or scalability available to support the higher complexity. Ongoing oversight and controls will be important, and appropriate contingency and agility of application in stressed circumstances should be considered.

On the other hand, there are operational limitations for some asset managers and asset servicers. Explicit costs are easier to process than implicit costs (such as market impact). Most practitioners that have implemented swing pricing have adopted a binary form of tiering with a single threshold approach but a multi-tiered approach is only adopted by a few.
Some fund administrators may be able deal to with this and multiple tiers or graduating level of cost, whilst others will not. There will also be an increased ongoing cost of running and maintaining it within the day to day environment. The more difficult challenge is having reliable data available, reviewed, validated and approved on a timely basis especially in the stressed market environment scenario(s). This is perhaps much simpler for firms on a common investment platform and with limited numbers of middle office and back office administration delegates. For firms /investment fund managers with multiple delegates, systems and multiple administrators servicing their products, the ability to standardize the processes and achieve consistency of process might be more challenging (consider 3rd party investment fund managers as an example who may rely on their investment manager and administration delegates to run the anti-dilution mechanism)
As previously mentioned it would be necessary to gain a full understanding of the rationale for and potentially document the rationale for the tiering intervals and how those are set. Tiering intervals will also likely differ by asset strategy.

In conclusion, ALFI believes that there should be discretion and flexibility for responsible entities. Nevertheless, thresholds should be based on objective criteria.

13. How could guidance on LMT calibration achieve a fair balance between (i) ensuring investors have a clear expectation of the cost of liquidity they could be charged and (ii) ensuring responsible entities have enough flexibility to attribute the overall cost of liquidity at all times, especially under stressed market conditions?

ALFI wants to underline that transparency and clarity of information is paramount for investors.

ALFI believes that in terms of investor expectation and awareness, it could be more formally embedded in the prospectus of the responsible entity (or private placement memoranda) and pre-contractual documentation with investors and intermediaries.

Responsible entities should also have clear procedures and policies in place, which lay out the methodology and approach to ensure consistency of approach and then disclose *ex post* on how often the anti-dilution LMTs have been applied.

ALFI believes that there should be greater dialogue and investor education around this subject. Greater standardisation of principles would help create more consistent messaging for the wider investor population (albeit the methodologies and business models may need to differ) and greater articulation of the components of dilution which responsible entities may wish to consider as dilutive and therefore adopt appropriate liquidity management techniques.

ALFI furthermore believes that good estimates, good governance, regular review processes, appropriate transparency, best practices are key. Nevertheless, the outcome will vary from responsible entity to responsible entity.

Whilst transparency and clarity of information is critical for investors, a key concern is not to provide too much information that might lead to behavior intended to circumvent the purpose of swing pricing. For example, if partial swinging is used and information concerning the level of thresholds were to

be freely available, a large and frequent trader may be able to determine the probability that the price will swing and thereby attempt to avoid application of the swing factor by trading just below that level. Therefore, certain details, such as the level of thresholds may remain confidential to ensure that such information cannot be used to the detriment of the fund.

On that basis, and although the principles of swing pricing are disclosed to investors, certain details may remain confidential certain categories of investors, e.g. UK defined contribution schemes, may require disclosure of swing examples and factors associated after the transaction. Where such increased transparency is being provided, it is essential to consider fair and equal treatment of all shareholders.
A fund considering a partial swinging process, using multiple thresholds and swing factors for each fund, which reduces the opportunity for arbitrage, may have different challenges concerning transparency. Accordingly, there may be less concern with transparency concerning the range of thresholds used. Conversely, with respect to swing factors in a multiple-threshold and swing factor environment, the range of swing factors could be commercially sensitive information, indicative of the investment manager's contracting capabilities. The release of this information to trading counterparties may lead to deterioration in dealing terms as the counterparties seek to profit from this information at the cost of underlying investors. It is therefore likely that, in the best interests of investors, managers will wish to retain a level of confidentiality over this information.
With regards to the swing factor, a challenge may exist for those building an element of market impact into the swing factor as, depending on how it is achieved, this could be considered commercially sensitive information which, if made public, could be used to the detriment of the fund.

Given that transparency in advance is challenging, and in respect of swing factors and swung/ unswung NAVs in a world of increasing transparency, it is becoming more common to provide the swing factor applied to impacted or potential investors upon request or to make provision of unswung NAVs, with an appropriate time delay (appropriate to be at the discretion of the manager).

A question therefore arises regarding the amount of information that should be provided in the fund constitutional documents, prospectus, financial statements and/or supplementary information.

The annual and semi-annual report of a UCI should provide for a description of the swing pricing mechanism.
Regulation (EU) No 1286/2014 on packaged retail and insurance-based investment products (PRIIPs) and Directive 2014/65/EU on markets in financial instruments (MiFID II) introduced a requirement to report transaction costs from investment funds to retail and institutional investors. Such cost disclosure includes implicit, explicit and anti-dilution components. Swing pricing compensates the transaction costs from capital activities, so that long-term investors do not bear the transaction costs of other shareholders investing/disinvesting. Hence if a fund is applying swing pricing, it can deduct the amount of the swing applied
from the transaction costs formula for PRIIPs and MiFID II reporting.
Asset managers should consider the level of connectivity necessary between their transaction cost calculation model under MiFID II/PRIIPs and their swing pricing model to seek to avoid inconsistencies in reporting.

As the European Directive 2009/65/EC, the Commission Regulation (EU) 583/2010 and the CESR (Committee of European Securities Regulators) papers in relation to the content of the key investor

information documents ("KIIDs") as well as the ESMA Q&A on KIID[2] do not refer to swing pricing, it should not be disclosed in the KIID. In accordance with (article 3 of) the Commission Regulation (EU) 583/2010, no information or statements other than those specified in this Regulation may be included in the KIID. The ALFI UCITS KIID Q&A address the question of whether swing pricing must be disclosed in the charges table, the answer to which is no. Swing pricing is not a charge but an adjustment in the NAV at which shares in the UCITS may be traded. Being a pricing model, it is not an essential feature of a fund in the sense required by the Commission Regulation (EU) 583/2010. However, as such it must be described in the fund prospectus.

14. Is the proposed approach regarding ranges of liquidity cost adjustment appropriate? If not, how could it be improved?

It could be appropriate as an approach but an estimated range (not wholly accurate) could be open to criticism. Responsible entities and national competent authorities would need to fully endorse the process as a best estimation rather than an accurate representation of the actual dilution.

ALFI would like IOSCO to bear in mind the range may well be very broad to encompass trading from very small to very large volumes. Any applicable fund regulation or notice/ transparency to investors needs to be navigated concerning both the range and any increases to the range on an exceptional basis. Nevertheless, envisaging and planning for exceptional increases via immediate fund website transparency to investors would facilitate quick amendments required by changing market conditions.

15. Is the proposed expectation on the level of confidence and the sophistication of liquidity cost estimations appropriate? If not, how could it be improved?

ALFI wants to outline that not all firms will have the same experience and will have been applying anti-dilution LMTs for an equally long period – and so may not yet have built up or evolved significant transaction cost data or sophisticated systems/models. This could be due to capability (expertise, technology etc) or limitations of local jurisdictional regulations.

Application of the types of implicit costs should be discretionary and not be mandatory for firms to apply.
As a key principle, historically much of what was implemented by firms was preventative. Having some degree of anti-dilution protection is better than none and the aim has always been to protect investors materially from dilution – it has not always sought nor is it perhaps possible to necessarily eliminate it entirely. Responsible entities need to strike a balance between implementing a mechanism that is representative and acts as a deterrent versus disproportionate costs and operational risk to eliminate dilution entirely.

Therefore, the proposals can be considered but they should not be enforced as described.

Examples of Good Practices
A top down approach is more common/practical/scalable in large asset managers than a 'bottom up' approach such as that suggested here for 'Calculation of Significant Market Impact'.

[2]https://www.esma.europa.eu/sites/default/files/library/esma34_43_392_qa_on_application_of_the_ucits_directive.pdf

Proposed Guidance 4 – Appropriate Activation

Threshold

16. What are the appropriate factors to consider in setting the activation threshold so that antidilution LMTs will be activated for any subscription / redemption activities with material dilution effect? How would you define 'material dilution effect'? Why and how could it vary across different funds?

The ALFI view is that it is effectively for each Responsible Entity to define what dilution is material to them, their funds and their client base, and that we would suggest points that managers should consider when setting their dilution thresholds, including where they would view dilution as becoming material. ALFI agrees with the proportionality envisaged by the comment "such LMTs are not expected to be activated at all times". Anti-dilution should primarily be a business as usual tool – used whenever applicable – based on investor flows
Portfolio holdings – very liquid holdings can probably have a higher liquidation threshold.
Size of net flows in relation to size (AUM) of the fund should be considered, as the normal size of investor flows and frequency of flows and the cumulative effect of small but frequent flows.
Automation – is it more practical to have the same level of threshold activation across all funds / all funds of a certain type?
Type of fund – index / tracker style funds would be impacted by lower volumes
Anti-dilution can be / should be a business as usual tool – used whenever applicable – based on investor flows.

The Responsible Entity should define the level of dilution that it will accept and put in place procedures to protect the fund from dilution above that eg 1 bp - given that the aim is to provide reasonable protection against dilution.

When considering the approach to dilution, ADL LMTs and thresholds it is important to strike the right balance between investor protection (e.g. percentage flows captured and level of dilution protection), operational effectiveness, transparency, short-term NAV volatility and tracking error, board and investor expectations and portfolio management considerations.

It is also relevant to consider the timing and levels of investor capital activity, both historic and prospective (if available). By way of example, funds with infrequent net capital activity and/or insubstantial net flows may
require a different approach to those with daily net capital activity and/or substantial net flows.

Considerations influencing the determination of the threshold may include:

- The type of threshold (percentage, monetary or a combination);
- will single or multiple/tiered thresholds be applied;
- The fund size;
- The fund client base and its concentration;
- The type and liquidity of securities in which the fund invests;
- The costs, and hence the dilution impact, associated with the markets in which the fund invests (although this will principally impact the factor);
- The investment manager's investment policy and the extent to which a fund can retain cash (or near cash) as opposed to always being fully invested;

- Consistency considerations within a fund complex - whether consistency of thresholds could be achieved without affecting the effectiveness of the AD LMT;
- The accepted level of client net capital activity for which transaction costs can be absorbed by the fund;
- Soft closure measures on capacity constrained funds, for example a fund closed to new subscriptions but which has contractually agreed to continue to accept small regular savings plan amounts;
- The frequency of the threshold review, and any specific triggers to review;
- Transparency considerations.

How would you define 'material dilution effect'?

- One approach could be to say any liquidity costs in aggregate that impact the value of the remaining shareholders investment in the fund by [x%/basis points] – either for a single or multiple threshold approach.

Why and how could it vary across different funds?

- Variations will occur due to market depth per asset class caused by supply and demand economics or actions taken by market authorities, governments and central banks.

17. Does the use of an activation threshold introduce the risk of trigger / cliff-edge effects?

How could trigger / cliff-edge effects be avoided? Could the tiered swing pricing address the trigger / cliff-edge effect?

Question 17, which is composed of multiple sub questions, is focused on swing pricing. ALFI tries to address all points in the below considerations on "single swing" and "multi-tiered swing".

Single Swing

- A single swing threshold and swing factor by construct has one threshold and so by its nature there must be some risk of cliff-edge effects.
  - The more obvious cliff-edge concern would normally be that certain investors may try to gain knowledge or estimate the one threshold and then place several deals over several days to avoid the swing factor.
  - Any one investor would not know the full fund dealing by all investors on a given day, only their own potential dealing, and so would have only partial knowledge.
- Nevertheless, ways that a responsible entity can counteract this potential for investor attempts at arbitrage are:
  - selective disclosure to potential investors: i.e. not advising current thresholds in place;
  - continual review and change of swing thresholds – e.g. if a responsible entity noticed a trend for deals just below the current threshold that still added up to a level of dilution that was considered not acceptable, then this could be counteracted by reducing the swing thresholds accordingly to capture that level of flows;
  - full swinging rather than partial swinging or a constant ADL/sub-red factor would also be ways to mitigate such effects but would have other consequences to cost, operational risk, nav volatility.
- A further cliff edge effect could be published NAV volatility, as the NAV per share will be more volatile on days when the fund swings and the following day when it resets. This could be somewhat counteracted by publishing the unswung NAV history periodically in arrears

Multi-tiered Swing

- This mitigates cliff-edge effects by replacing the single swing model of one threshold and one swing factor with several thresholds & associated factors per threshold, in a tiered approach. If there is considered to be a cliff-edge in this model, it is one of many much smaller cliffs. Conceptually there could be any number of thresholds and associated swing factors. Operational practicalities will have a significant bearing on the number adopted.
- Multiple swing is a newer operational model, less common in the marketplace and there could be several ways in which to implement it. Funds generally swing much more regularly but by smaller amounts. There is less noticeable impact on nav volatility. If an investor wishes to break large trades into several smaller ones over several days the model will still capture these and protect against dilution accordingly.
- However, there is no panacea because this model being more complex and with much higher volumes, comes with greater risk of operational error, a greater focus on automation and controls, a greater cost, longer time to market and requires greater maintenance. Not all asset managers may feel the risk or additional costs are warranted and may be comfortable with their existing anti-dilution capability. Not all service providers will have capability to service their clients to what may be enhanced expectations.

Both of the above outlined models can be changed quickly in stressed market conditions but flexibility is important so that the responsible entity may act quickly, when necessary, to protect against material dilution.
ALFI suggests that it should be left to the responsible entity to determine the most appropriate LMTs and ADLs for their business.

Proposed Guidance 5 – Governance

18. Do the proposed arrangements discussed above include all the essential elements regarding governance and oversight arrangements in relation to the use of anti-dilution LMTs? Are they proportionate to the differing size and complexity of responsible entities' fund ranges?

We agree on the need for the Responsible Entity to put in place appropriate governance, but there is not necessarily need for a separate mandated Internal Governance Committee as outlined in the IOSCO consultation paper. This responsibility could be fulfilled by the Responsible Entity itself or by its delegates, a swing pricing committee, or any other grouping. ALFI would suggest that responsible entities have policies and procedures in place that formally outline the framework and the oversight controls.
This may be particularly relevant for a smaller fund manager where no delegates are necessary.

Review and Escalation processes should include a significant change in fund size.

Strong governance processes should incorporate:
- Clear documentation of roles and responsibilities.
- Approved terms of reference or equivalent documentation should define the extent of powers delegated, membership of the governing body, frequency of meetings and nature and frequency of reporting responsibilities.
- There should be clearly documented policies, which could, but do not have to, be incorporated into the terms of reference.

- Meetings and decisions should be appropriately documented, with a critical focus on any variations from application of the standard policy.
- It is recommended that swing factors/spreads/amount of ADL/red-sub fee, and any thresholds, be regularly reviewed (e.g. on a monthly or quarterly basis) and back-tested (e.g. in light of actual transaction costs or spreads incurred by the funds) to ensure reasonability, and that they be revised as and when necessary.
- Operational risk should also be considered in the context of
  - how swing factors / spreads / anti-dilution levy / sub-red fee are communicated from the governing body to the party charged with execution be that fund accountant / transfer agent
  - increased risk caused by manual processes

19. Please describe any material factors of the governance and oversight arrangements which have not been included.

ALFI wants to refer to the responses above. In addition, we want to add:

- Fund auditor – continuous audit has been shown to be a helpful review process.
- A specialist committee to implement run and oversee process with appropriate reporting.
- A governance committee is not necessarily required *(see also response under Q18 above)*.
- A separate committee empowered to act quickly / daily is often put in place when the responsible entity may only meet infrequently.
- Internal governance could be covered by appointing specialist committee/s as delegates of the responsible entity with regular reporting at agreed intervals flowing back (with mechanisms to deal with exceptional circumstances).
- The Portfolio Manager should be a reference point invited for Governance or decision-making purposes but all decisions and oversight should be made independent of its influence.
- Documentation of *ad hoc* and exceptional decisions. Definition of what constitutes a material event. The powers and limits of the governance and oversight entity.
- Processes around launch of and liquidation of funds and corporate actions like redemptions-in-kind.

Proposed Guidance 6 – Disclosure to Investors

20. Is the ex-ante information described above likely to be appropriate and effective in explaining the use of anti-dilution LMTs to investors? What other information about dilution, if any, might be helpful to investors before they invest in a fund?

ALFI believes that this is indeed appropriate. ALFI wants to further outline that members have come up with their own "Swing Pricing" flyers to address their investors and where applicable matters such as market impact.

ALFI believes that explanations on the long-term benefits to the fund at a macro level of applying dilution protection should be considered.

The IOSCO suggestions could be complemented by referencing:

- Industry guidelines – e.g. ALFI Swing Pricing Guidelines –whereby market participants have a dialogue and define and document best practices sharing group knowledge and experience.
- Regulator FAQ documents – e.g. CSSF FAQ on Swing Pricing which outlined CSSF thoughts, suggestions and expectations in certain specific areas – which allowed flexibility whilst simultaneously clarifying regulator expectations and requirements, and structured in a manner sufficiently flexible to facilitate updates at short notice when required
- Asset Manager 'Swing flyer' on AM internet providing more detail than could be provided in a prospectus on:
  - what anti-dilution is, how it works, how it protects shareholders and why it should be used;
  - each individual managers' practices and policies;
  - governance.
- Dynamic information should be disclosed outside of fund prospectus and articles which may be very infrequently amended.
- Historic ex-post disclosures would also need to be provided on asset manager internet sites as the volumes would be far too great to be accommodated in annual/ semi-annual fund financial statements.

Whilst appropriate records will always be retained, where anti-dilution is used as a business as usual tool, the extent anticipated of a tracker of when used may not be sustainable or scalable

In addition:

1) If all investment funds were on a level playing field in terms of being required to have some form of anti-dilution levy mechanism implemented then there could be more ready acceptance by investors.
2) Internal controls environments and the methodologies of the mechanism must be robust. Information on the details of the methodologies should be kept proprietary to the committee to avoid leaking and potential gaming.
3) The consultation also should better consider the impacts of cumulative day on day dilution events.

21. What information can (and should) be disclosed ex-post to investors or the public, and at what frequency, to enhance transparency without compromising the aims of the antidilution LMTs or creating unintended consequences?

Whether an LMT has been applied and on what days, swing amount, direction, date

- The value periodically of the dilution adjustment retained by the fund to protect investors.
- Suggest periodically in arrears via website (e.g. monthly/ quarterly).
- Upon request from a transacting shareholder – the amount of swing factor applied and which direction the fund swung.
- A record of the daily NAV before and after application of an anti-dilution tool should be retained and could be made available periodically in arrears.
- There could be development time lags and cost issues for impacted responsible entities.
- A responsible entity could consider disclosing the highest and lowest swing factors / anti-dilution levy applied during the year.

22. Are there other risks than those described in this section attached to the disclosure of the parameters used for anti-dilution tools?

Entities should have discretion according to their business model for applying the LMT to ensure that they don't reveal proprietary information which might allow certain investors to game the mechanism.

- Single swing – risk of gaming thresholds by investors.
- Multiple swing – risk of terms of business with brokers becoming more transparent to the commercial detriment of the fund.
- Shareholders may rely on info received ex ante that could be out of date.
- From that perspective, ex post could be preferable – actual swing factor or unswung NAV – unswung NAV is probably preferable as this can be automated on a website and as any disclosure needs to be robust and scalable but s this is a share class level there would be a high volume of data.

Overcoming Barriers and Disincentives

23. Do you agree with the list of barriers and disincentives identified? Do you consider there are others that are not covered?

- Operational risk of error or delay.
- Lack of understanding or familiarity by investors or regulators.
- Degree of investment, technology & people, experienced specialist knowledge required at both the Responsible Entity and at any delegates – together with lead time to develop or acquire.

24. In your view, what are the most significant barriers or disincentives to the implementation of anti-dilution LMTs? What are your suggestions for possible solutions to mitigate or overcome the barriers and disincentives to the implementation of anti-dilution LMTs?

ALFI believes that if the parameters of LMT - such as the inclusion of significant market impact - were to be mandated, this could prevent a broader adoption of anti-dilution LMT's that capture the majority of dilution incurred. This will be partly due to inconsistent availability of data, across the industry, preventing a single standard operating model.

- Each responsible entity to document their evaluation of industry guidelines, in regard to both each funds' anti-dilution requirements and manager capabilities, and reasons/rationale for adherence or otherwise;
- Flexibility in regards to each responsible entities' application of the required anti-dilution tool would increase the adoption and ability to implement appropriate processes and data automation.

Data availability & expert knowledge can take time for firms (responsible entities) to build up with certain regions and firms not having a depth of prior experience and history. Differing global fund distribution models can create inconsistencies in regard to data availability e.g. investor flows when calculating the daily NAV.

- ALFI believes that industry bodies could further develop guidelines that will enable fund accountants and transfer agents to automate processes for both providing reliable estimates of daily fund flows and the subsequent application of the same.

Automation could be a challenge from a cost / capability / prioritisation perspective:

- Flexibility in regards to the parameters to be applied would reduce costs and enable firms to incrementally develop their models.

Lack of familiarity by certain investors combined with short termism by certain investors may result in a failure to see the benefit from being protected in the fund as their involvement at that point in time may be relatively passive. When active (subscribing and redeeming) the emphasis and focus is often on the degree of impact upon them in the moment.

- ALFI believes that investor education and communications is key – in respect of shareholder benefits, specific anti-dilution requirements of each fund and the tools implemented.

More consistent adoption of liquidity management principles by national competent authorities would also add to the familiarity of Investors with regard to their application and the protection they can offer against dilution.

25. For those OEFs facing significant barriers, what are the implications for their ability to implement this guidance? Are adjustments needed to the guidance to account for this, bearing in mind the objective to mitigate dilution for investor protection?

- The flexibility outlined is positive recognizing that there can be different ways to achieve the same aim.
- Something is better than nothing, so flexible approaches.to build capability rather than a cliff edge approach.

26. Do you have any other comments on any guidance proposed in this document?

- ALFI is generally supportive of the IOSCO consultation report and its proposed guidance.
- ALFI wants to highlight that not all deals in a stressed market condition are First Mover Advantage related – e.g. there were significant asset allocator movements in March/April 2020.
- ALFI would like to highlight that anti-dilution mechanisms are primarily business as usual (BAU) tools to protect long-term investors, rather than a liquidity management tool.
- ALFI wants to stress that some managers may not yet have implemented anti-dilution LMTs as BAU/standard or some may only be in the early stages of doing so.
- Some managers may be large and very sophisticated, but not all will have developed practices in this respect to the same level. IOSCO guidelines therefore need to accommodate all ends of the spectrum.
- Definitions such as “normal markets”, “stressed markets”, “significant” and “material” should be left to each responsible entity to define for their business.
- ALFI believes that it is paramount to retain proportionality and flexibility. Particularly the ability to react quickly when markets become stressed.
- Cost / benefit criteria should be considered by responsible entities when considering the appropriate ADL LMT to apply to their business.