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July 11, 2023

FSB and IOSCO Publish Consultations on Liquidity Risk Management in Open-Ended Funds

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TO: ICI Members
ICI Global Members
Asia Regulatory and Policy Committee
Europe Regulatory and Policy Committee
Liquidity Rule Implementation Working Group
SEC Rules Committee SUBJECTS: Disclosure
Fees and Expenses
Fund Accounting & Financial Reporting
Fund Governance
International/Global
Operations
Portfolio Oversight
Recordkeeping
Risk Oversight
Settlement
Valuation RE: FSB and IOSCO Publish Consultations on Liquidity Risk Management in Open-Ended Funds

On 5 July, the Financial Stability Board (FSB) and International Organization of Securities Commissions (IOSCO) each published consultations on liquidity risk management in open-ended funds (OEFs).[1] The FSB and IOSCO are accepting feedback on the consultations by 4 September.[2] Please contact me at kirsten.robbins@ici.org if you would like to provide input into ICI's responses to the consultations. Drafts of ICI's comment letters will be circulated for member input. The consultations are summarized below.

Background

The FSB and IOSCO have engaged in work regarding liquidity risk management in OEFs for many years. In 2017, the FSB published policy recommendations to address the risks the FSB identified to financial stability arising from structural liquidity mismatch in OEFs (2017 FSB Recommendations).[3] In 2018, IOSCO published a final report with recommendations for liquidity risk management in collective investment schemes (2018 IOSCO Recommendations),[4] supplemented with a set of related good practices (2018 IOSCO Good Practices).[5]

Following the events of March 2020, the FSB and IOSCO undertook assessments of their 2017 and 2018 recommendations. IOSCO's Assessment Committee conducted a thematic review of the extent to which participating IOSCO member jurisdictions had implemented the regulatory measures in the 2018 IOSCO Recommendations.[6] The FSB assessed its 2017 Recommendations regarding the financial stability risks arising from liquidity mismatch considering recent experience.[7]

The FSB and IOSCO assessments were conducted as part of the FSB's Non-Bank Financial Intermediation (NBFI) work programme,[8] which has focused on perceived vulnerabilities that the FSB has identified as causes of excessive liquidity demand spikes.

IOSCO Consultation

The IOSCO Consultation seeks to address dilution, whereby subscribing or redeeming OEF investors subscribe or redeem at a net asset value (NAV) that does not reflect the liquidity costs associated with these transactions, particularly during stressed market conditions. The proposal asserts that investor protection concerns arise when investors that remain in the fund are disadvantaged in bearing these liquidity costs.

The proposal is intended to address the potential for financial stability concerns to arise where dilution is material and incentivizes investors to redeem to get ahead of other investors with similar concerns, a "first-mover advantage." Under this theory, first-mover advantage may give rise to excess redemptions and OEFs' sales of portfolio assets to meet the redemptions may contribute to greater market volatility and additional pressure on asset prices. The consultation also acknowledges, however, citing ICI research, that there is evidence that first-mover advantage dynamics exist at a market-wide level and may not be a unique feature of OEF structure.[9]

To address the investor protection and potential financial stability concerns, the IOSCO Consultation proposes detailed guidance regarding OEFs' use of anti-dilution Liquidity Management Tools (LMTs). The proposal recognizes the crucial role of OEF liquidity risk management in their orderly functioning and to protect investors. It also identifies anti-dilution LMTs as a critical component of OEFs' overall liquidity risk management framework.

The proposed guidance would require responsible entities, such as OEF managers, to design, use, and be able to activate one of five identified anti-dilution LMTs to address material dilution: swing pricing, valuation at bid or ask prices, anti-dilution levies, dual pricing, and redemption fees. The guidance would not require OEFs to have tools always activated and discusses appropriate activation thresholds. The proposal recognizes that OEFs provide investors with the benefits of collective investing, and accordingly investors should expect to share transaction costs and other costs of the OEF, so long as such costs are not disproportionate. Additionally, the proposed guidance permits responsible entities to set activation thresholds for each OEF they manage, appropriately and prudently.

Although IOSCO purports to present the LMTs in a balanced manner, by not promoting any tool over others and by providing an objective comparison, it identifies tiered swing pricing as an example of a good practice that facilitates clear and systematic implementation while taking proportionality into account.

The proposed guidance provides that the anti-dilution tools used by the responsible entity should impose on subscribing and redeeming investors the estimated cost of liquidity, i.e., explicit and implicit transaction costs of subscriptions or redemptions, including any significant market impact of asset purchases or sales to meet those subscriptions or redemptions. IOSCO acknowledges that estimating explicit costs would be easier than implicit costs, particularly in stressed market conditions. Responsible entities would be required to assess the materiality of estimated market impact and determine whether to calibrate the anti-dilution LMTs based on such assessment.

The proposed governance recommendations focus on having internal governance arrangements that cover objective criteria for the application of anti-dilution LMTs; methodology, including for calibration, of anti-dilution LMTs; parties involved in governance, their respective functions and responsibilities and coordination; sources of information and data to be used; controls to be carried out (such as reviews) and their frequency; documentation of recommendations and decisions; and escalation processes and oversight. Specific arrangements are not mandatory, but rather governance should be appropriate for the fund in light of its characteristics and context. The proposal also identifies the relevant skills and knowledge that relevant fund staff should have.

The proposed guidance would require responsible entities to publish clear disclosures of the objectives and operation (including design and use) of anti-dilution LMTs to improve awareness among investors and enable them to better incorporate the cost of liquidity into their investment decisions and mitigate potential adverse trigger effects. The proposal states specifically that fund documents should indicate that the main purpose of anti-dilution LMTs is to facilitate fair treatment of investors by protecting the ones that remain invested from bearing the costs generated by the subscription and redemption activities of others.

IOSCO also recommends that responsible entities put in place measures to enable LMTs that are permitted under applicable law and regulations to be used promptly and in an order manner. It acknowledges, however, that there are several barriers and disincentives to the use of anti-dilution LMTs, which fall into the categories of negative perceptions and market-wide and operational barriers. IOSCO proposes limited solutions to addressing these challenges. Negative perceptions are proposed to be mitigated through adoption and use of anti-dilution LMTs by all OEFs. IOSCO proposes that further mitigation may occur where anti-dilution LMTs benefit OEF performance. Operational barriers may be reduced over time as OEFs and authorities review and improve the tools and standardize and automate related practices. IOSCO also identifies communication and investor education as means to facilitate greater use of anti-dilution LMTs but does recognize that certain market-wide barriers cannot be overcome through these means. Rather, complex solutions implemented by parties other than responsible entities would be required.

FSB Consultation

The FSB is proposing revisions to its 2017 Recommendations to address liquidity mismatch in OEFs in conjunction with the IOSCO proposal. It defines structural liquidity mismatch as the difference between the redemption terms that an OEF offers to investors and the amount of time it may take the fund's manager to liquidate holdings in an orderly manner (e.g., without substantially increasing transaction costs or impacting prevailing market prices. The FSB presumes that liquidity mismatch can amplify liquidity shocks through first-mover advantage driving excess redemptions and investors not understanding the true cost of liquidity and acting differently than they would if holding the same assets directly.

The FSB's proposal defines two categories of liquidity management measures and tools. The first category is measures and tools to reduce structural liquidity mismatch, which includes lowered redemption frequency and lengthened notice/settlement periods. The second category is measures and tools to reduce shock amplification and transmission arising from liquidity mismatch which include the use of anti-dilution LMTs, use of quantity-based LMTs, and the use of other liquidity management measures, particularly in stressed market conditions.[10]

The focus of the FSB's proposal is on two sets of revisions to its 2017 Recommendations. The first proposes to revise Recommendation 3 to reduce structural liquidity mismatch and articulate the redemption terms that OEFs should offer based on the liquidity of the assets in which the fund invests. The 2017 recommendation is high-level. While the 2017 Recommendation seeks to align redemption terms with the liquidity of investment assets, it does not specify how that should be accomplished. The proposed revisions provides more specific recommendations tailored to three categories of funds: mainly investing (50% or more) in liquid assets, allocating a significant proportion (30% or more) to illiquid assets, and mainly investing (50% or more) in less liquid assets.

- Mainly investing in liquid assets. For funds that mainly invest in assets that are liquid in both normal and stress periods, the FSB proposes that such funds could continue to offer daily dealing. Such funds would include those can be readily converted into cash without meaningful market impact in normal and stressed conditions. These OEFs should enhance their liquidity management practices and pass on redemption costs to the redeeming investors, consistent with the proposed revisions to other recommendations and the IOSCO proposal.
- Allocating a significant proportion to illiquid assets. The most stringent proposed recommendations are for these funds. The FSB proposes that these funds offer less frequent redemption terms and/or require long notice or settlement periods. The proposal does not identify a specific minimum redemption term or notice/settlement period and does not provide guidance on how to determine the appropriate redemption term or notice/settlement period.
- Mainly investing in less liquid assets. This category of funds is defined based upon investment in assets that are less liquid in normal times and susceptible to illiquidity in times of stress. The FSB proposes that such funds may offer daily dealing without notice/settlement periods where fund managers are able to demonstrate to authorities that the funds can implement anti-dilution LMTs that pass on to redeeming investors the explicit and implicit costs of selling assets in normal and stressed market conditions, including any significant market impact of asset sales. Where funds are not able to make this demonstration to supervisors, they would need to consider reducing redemption frequency or implementing longer notice or settlement periods, as considered appropriate by authorities.

Where funds invest in assets in an amount or type that does not fit into the three types described above, the FSB proposes that the fund manager use prudence to determine the appropriate approach, upon a demonstration to authorities.

The second set of proposed revisions to the FSB's 2017 Recommendations seek to address reducing shock amplification and transmission using anti-dilution LMTs. The FSB aims to mitigate what it views as potential first-mover advantage and the associated financial stability risk. The FSB proposes that authorities ensure that a broad set of LMTs, including both anti-dilution and quantity-based LMTs, are available to OEF managers in normal and stressed conditions. The proposal would also require authorities to ensure that OEFs consider and use anti-dilution LMTs and enhance investor awareness regarding the objectives and operation of these tools. The FSB also recognizes that fund managers have the primary responsibility with regards to the consideration and use of quantity-based LMTs and other liquidity management measures, but proposes that authorities provide guidance on the use of these tools, particularly in stressed conditions.

The FSB cautions against reliance on quantity-based LMTs, since there could be unintended procyclical consequences. While the FSB proposal promotes anti-dilution LMTs as effectively able to mitigate first-mover advantage and excess asset sales, it does note that such LMTs might not reduce redemptions driven by other factors such as a dash-for-cash or flight-to-safety.

Next Steps

Comment letters on each of the proposals are due on September 4. The FSB and IOSCO intend to finalize these proposals by the end of the year.[11]

IOSCO will also develop guidance on quantity-based LMTs and the FSB's recommendations regarding OEF design and publish a proposal in early 2024.[12]

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endnotes

[1] Addressing Structural Vulnerabilities from Liquidity Mismatch in Open-Ended Funds - Revisions to the FSB's 2017 Policy Recommendations (FSB Consultation), 5 July 2023, available from https://www.fsb.org/wp-content/uploads/P050723.pdf ; Anti-dilution Liquidity Management Tools - Guidance for Effective Implementation of the Recommendations for Liquidity Risk Management for Collective Investment Schemes (IOSCO Consultation), 5 July 2023, available from https://www.iosco.org/library/pubdocs/pdf/IOSCOPD739.pdf

[2] See Press Release: FSB consults on policies to address vulnerabilities from liquidity mismatch in open-ended funds, (FSB Press Release) 5 July 2023, available from https://www.fsb.org/wp-content/uploads/R280623.pdf ; Press Release: IOSCO Proposes Detailed Guidance for Open-Ended Fund use of Anti-Dilution Liquidity Management Tools, 5 July 2023, available from https://www.iosco.org/news/pdf/IOSCONEWS701.pdf

[3] Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities,

[4] Recommendations for Liquidity Risk Management for Collective Investment Schemes, 1 February 2018, available from https://www.iosco.org/library/pubdocs/pdf/IOSCOPD590.pdf

[5] Open-ended Fund Liquidity and Risk Management - Good Practices and Issues for Consideration, 1 February 2018, available from https://www.iosco.org/library/pubdocs/pdf/IOSCOPD591.pdf

[6] Thematic Review on Liquidity Risk Management Recommendations, 16 November 2022, available from https://www.iosco.org/library/pubdocs/pdf/IOSCOPD721.pdf

[7] Assessment of the Effectiveness of the FSB's 2017 Recommendations on Liquidity Mismatch in Open-Ended Funds, 14 December 2022, available from https://www.fsb.org/wp-content/uploads/P141222.pdf

[8] The FSB's NBFI Work Programme was set forth in its Holistic Review of March Market Turmoil, 17 November 2020, available from https://www.fsb.org/wp-content/uploads/P171120-2.pdf. The FSB carries out this work in conjunction with its members and other standard-setting bodies, including IOSCO. In 2022, the FSB published a progress report on its NBFI work and set forth an overview for its planned work. See Enhancing the Resilience of Non-Bank Financial Intermediation: Progress Report, 10 November 2022, available from https://www.fsb.org/wp-content/uploads/P101122.pdf

The NBFI work programme aims to

1) perform analytical and policy work to examine, and where address specific issues that contributed to market turmoil in 2020;

2) develop a systemic risk perspective in NBFI to enhance understanding of systemic risks in NBFI and strengthen their ongoing monitoring; and

3) develop policies to address systemic risks in NBFI, including by assessing the adequacy of existing policy tools given the desired level of resilience for the sector.

[9] IOSCO Proposal at n7.

[10] The proposal generally refers to "anti-dilution LMTs" rather than "price-based LMTs" and replaces the term "exceptional LMTs" with references to quantity-based LMTs and other liquidity management measures.

[11] See IOSCO Consultation at 5; FSB Press Release at 2.

[12] See IOSCO Consultation at 8.