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FSB and IOSCO Finalize Reports on Liquidity Risk Management for Open-Ended Funds

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TO: ICI Members
ICI Global Members
Asia Regulatory and Policy Committee
Europe Regulatory and Policy Committee
Financial Stability and OEF Working Group
Global Operations Advisory Committee
Liquidity Rule Implementation Working Group
Operations Committee
SEC Rules Committee
Securities Operations Advisory Committee SUBJECTS: Financial Stability
International/Global RE: FSB and IOSCO Finalize Reports on Liquidity Risk Management for Open-Ended Funds

On December 20, 2023, the Financial Stability Board (FSB) and International Organization of Securities Commissions (IOSCO) each published final reports on liquidity risk management in open-ended funds (OEFs),[1] following their respective July 2023 consultations on the subject.[2]

In its response to the July 2023 consultations, ICI Global expressed general support for the FSB's and IOSCO's work, including several aspects of proposed revisions that recognized the benefits of collective investing and promoted robust liquidity management.[3] ICI Global, however, did not support aspects of the FSB and IOSCO consultations that would have restricted OEF managers' discretion to manage liquidity risks in the interests of investors. Specifically, ICI Global:

1. Demonstrated through research and analysis that not all funds experience material dilution and therefore the proposed requirement for all OEFs to consider and use an anti-dilution liquidity management tool (LMT) was too broad and prescriptive;
2. Opposed mandating all funds to incorporate estimates of market impact into their calibration of anti-dilution LMTs; and
3. Encouraged the FSB to eliminate the proposed prescriptive fund liquidity bucketing

framework.

The FSB and IOSCO Final Reports reflect revisions to each of these issues in light of comments from ICI Global and other respondents. Key outcomes include:

1. Eliminating the proposed requirement for all OEFs to consider and use an anti-dilution LMT. The FSB and IOSCO Final Reports clarify that anti-dilution LMTs should be used where appropriate with the objective of mitigating material dilution but that not all funds may experience material dilution.
2. Clarifying that funds only need to incorporate estimated market impacts into the calibration of LMTs when the impact would be material, and that such estimates may be made based on reasonable efforts.
3. Largely maintaining the liquidity bucketing approach for funds, but with some modifications such as clarifying that fund categorization generally is intended to be a static, ex-ante exercise, subject to periodic review.

As a next step, in 2024, IOSCO will undertake work to revise its 2018 policy recommendations and good practices for liquidity risk management to incorporate the FSB and IOSCO Final Reports.[4] ICI Global will remain closely engaged with IOSCO and its members as this implementation work moves develops.

Looking forward, in 2026, the FSB and IOSCO will undertake a stocktake of the measures taken to implement the Final Reports, followed in 2028 by a determination of whether further action is necessary.

Additional details on the IOSCO and FSB Final Reports are summarized below.

IOSCO Final Report

The IOSCO Final Report provides guidance to responsible entities for OEFs, such as fund managers. It is intended to support the effective implementation of IOSCO's 2018 policy recommendations and good practices for liquidity risk management.

IOSCO recognizes the benefits of OEFs, including to reduce systemic risk. The IOSCO Final Report continues to recognize that there cannot be a one-size-fits-all approach to OEF liquidity risk management and that fund managers are best placed to decide whether and how to use LMTs.

Use of Anti-dilution LMTs and Financial Stability Risk

IOSCO continues to express concern that investor protection and financial stability concerns could arise when OEF investors that exit a fund do not bear the costs of liquidity associated with their redemptions, to the detriment of investors remaining in the fund.[5] In response to comments, the IOSCO Final Report reflects more nuance, with IOSCO acknowledging that some hold the view that there is insufficient evidence to support the first-mover advantage theory.[6]

The IOSCO Final Report presents guidance on anti-dilution LMTs to address policymakers' concerns regarding the financial stability and investor protection risks associated with dilution in OEFs.

IOSCO establishes a framework for anti-dilution LMTs with five elements:

- Design and use, including:
    - types of anti-dilution LMTs (Element (I)),

    - calibration of liquidity costs (Element (II)),
    - and appropriate activation threshold (Element (III));
- Oversight by OEF manager boards and depositaries through governance (Element (IV)); and
- Disclosure to investors about the use of anti-dilution LMTs (Element (V)).

The IOSCO Final Report addresses elements through six main points of guidance and accompanying explanatory text.

Role of Anti-Dilution LMTs (Guidance 1)

IOSCO continues to identify five of the most commonly used anti-dilution LMTs - swing pricing, valuation at bid or ask prices, dual pricing, anti-dilution levies, and subscription/redemption fees. In response to industry feedback, the IOSCO Final Report clarifies the flexibility that OEF managers have in managing liquidity. The report is revised to reduce the importance of anti-dilution LMTs and indicate that these tools are not the only mechanisms through which OEFs can mitigate the financial stability concerns. Rather, OEFs' existing liquidity management frameworks can be used to address both investor protection concerns and to mitigate financial stability risk.[7]

Use of Anti-Dilution LMTs (Guidance 2)

While the IOSCO Final Report continues to seek to expand the availability and use of anti-dilution LMTs broadly, the final text introduces additional flexibility and proportionality regarding the use of anti-dilution LMTs. In response to comments on the consultation, the IOSCO Final Report eliminates the proposed requirement for all OEFs to consider and use an anti-dilution LMT. OEFs should use anti-dilution tools where appropriate to mitigate material dilution but clarifies that not all funds may experience material dilution.

IOSCO appreciates that "[s]ince dilution risk differs between OEFs, the application of appropriate anti-dilution LMTs to achieve these objectives may also differ between OEFs."[8] The IOSCO Final Report reflects that for many funds, the costs associated with adopting and using anti-dilution LMTs could outweigh the benefits, that is where there the fund does not experience material dilution. In applying anti-dilution LMTs, OEFs should seek to treat both exiting and remaining investors fairly. Thus, the IOSCO Final Report gives flexibility to OEF managers to determine when using an anti-dilution LMT would be appropriate.

The final text of Guidance 2 in the IOSCO Final Report states:

> As part of their liquidity risk management framework, responsible entities should consider and use appropriate anti-dilution LMTs for OEFs under management (where appropriate as per the explanatory text set out below) to mitigate material investor dilution and potential first-mover advantage arising from structural liquidity mismatch in the OEFs they manage. [9]

IOSCO does not explicitly state for which funds the use of anti-dilution LMTs would be appropriate nor provide exemptions or exclusions for any specific types of funds.[10] IOSCO notes that defining fund types is difficult. OEFs and their investments are not static, so the associated liquidity risks are also dynamic. IOSCO expects the added flexibility and proportionality are sufficient to address concerns that anti-dilution LMTs are not appropriate for funds investing in very liquid assets and in mainly illiquid assets.

Calibration of Anti-Dilution LMTs (Guidance 3)

IOSCO's anti-dilution LMT framework provides guidance on calibrating anti-dilution LMTs to OEFs that use these tools. Through the calibration, OEFs should ensure that fund investors bear their own liquidity costs, where such costs would result in material dilution. The calibration consists of two components, explicit costs and implicit costs, the latter of which incorporates estimates of significant market impact. OEFs using anti-dilution LMTs need to be able to demonstrate to authorities that their calibration is appropriate and prudent for both normal and stressed conditions.

IOSCO received significant opposition to its proposed requirement that OEFs incorporate calculations of significant market impact into their calibration of anti-dilution LMTs. In response to these comments, the IOSCO Final Report clarifies that OEFs only need to incorporate the estimated market impact into the calibration when the impact would be material. The IOSCO Final Report gives flexibility to OEFs to define when the impact would be significant, following a materiality assessment.

In the consultation, IOSCO had recognized some challenges in estimating market impact proposed funds to do so on a best effort basis. The IOSCO Final Report provides further clarification that OEFs should be able to demonstrate to authorities that they have made reasonable efforts to arrive at fair and reasonable estimates, considering data limitations, and that developing processes for estimating market impact will evolve over time.

IOSCO also received significant feedback regarding its use of a pro-rata slice approach[11] as an example of how to calibrate liquidity costs. The revisions in the Final Report clarify that funds should estimate liquidity costs using "professional judgement" "on a fair and reasonable basis," removing an expectation that funds should calibrate anti-dilution LMTs "conservatively." The IOSCO Final Report concedes that a pro-rata slice approach may not represent a fair estimate of liquidity costs or be in the best interests of all investors and confirms that funds may use an alternative approach to estimate liquidity costs.

Activation of Anti-Dilution LMTs (Guidance 4)

For OEFs that use anti-dilution LMTs, the IOSCO Final Report continues to permit OEFs to not have the tool activated at all times. IOSCO incorporates flexibility for OEF managers to set different activation thresholds for each fund they manage, consistent with the principle that there is no one-size-fits-all approach to OEF liquidity risk management. Consistent with the consultation, activation thresholds should be set appropriately and prudently so as not to result in material dilution impact. IOSCO recognizes several factors that funds should consider in setting thresholds, adding historical fund flows, based on ICI Global's comments.

Governance (Guidance 5)

The anti-dilution LMT framework emphasizes governance over the establishment and use of anti-dilution LMTs. For OEFs using anti-dilution LMTs, the internal governance arrangements should address:

- objective criteria for the application of anti-dilution LMTs (including activation thresholds);
- the methodology for using anti-dilution LMTs, including calibration; and
- the roles and functions of parties involved in managing, risk managing, and administering anti-dilution LMTs.

An OEF's governance arrangements for anti-dilution LMTs should be commensurate with the portfolio profile and should be properly documented. The IOSCO Final Report clarifies that the governance framework should address adequate approval levels to ensure that there are no unwanted or inappropriate modifications of the arrangements for using anti-dilution LMTs.

IOSCO proposed that the appropriate mechanism for the governance function is an internal governance committee composed of persons of suitable seniority and adequate skills and knowledge. In the Final Report, IOSCO makes some practical clarifications. A fund may adopt other appropriate governance arrangements, depending on the corporate organization structure. IOSCO expects that the oversight arrangements will be commensurate with the operations of the OEF's responsible entity and that, in some cases, oversight may be performed by an individual. In risk managing anti-dilution LMTs, it may be possible to leverage work performed and data gathered for other purposes. External third parties, such as fund depositaries or external auditors may have a role with respect to anti-dilution LMT governance, but the IOSCO Final Report these parties may not have a role in all jurisdictions and only applies this portion of the guidance where there is a relevant regulatory requirement.

Disclosures (Guidance 6)

IOSCO prioritizes investor disclosure and education to reduce the potential stigma associated with the use of anti-dilution LMTs and to enhance investors' understanding of the costs of liquidity. The IOSCO Final Report addresses anti-dilution LMT disclosures, recognizing the need to balance transparency with unintentional adverse effects.

While IOSCO received several comments requesting more limited disclosures of the calibration of anti-dilution LMTs and activation thresholds to reduce the potential for attempts to game the system, the Final Report on this point is substantively unchanged from the consultation. The IOSCO Final Report suggests that funds mitigate concerns about disclosing too much information by using ranges.

FSB Final Report

The FSB Final Report revises the FSB's 2017 recommendations to address liquidity mismatch in OEFs[12] and is intended to be read in conjunction with the IOSCO Final Report. The FSB's policy recommendations are directed at authorities and set forth the objectives for an effective regulatory and supervisory framework to address vulnerabilities arising from liquidity mismatch in OEFs. In revising the recommendations, the FSB's goal is to strengthen the OEF managers' liquidity risk management through greater use of and greater consistency in the use of anti-dilution LMTs.[13]

Liquidity Categories (Revised Recommendation 3)

The FSB's Recommendation 3 seeks to align redemption terms that OEFs can offer to investors with the liquidity of the OEF's asset holdings. The revisions in the FSB Final Report are intended to provide greater clarity on how authorities should apply this recommendation.

The FSB Final Report presents a framework that categorizes OEFs as "liquid," "less liquid," or "illiquid," and provides guidance for authorities on the expected and appropriate dealing terms for funds within each of these categories. While the FSB uses the term "categorization" rather than "bucketing," which was used in the consultation, the concept is similar, with some key changes.

The FSB does not provide any examples of funds that might fall within a particular category but describes the liquidity of assets:

- "Liquid assets" are defined as those that can be readily converted into cash without significant market impact in both normal and stressed markets.
- "Less liquid assets" are defined by liquidity that is contingent on market conditions. In normal market conditions, these assets are generally readily convertible into cash without significant market impact, but in stressed market conditions, they may not be readily convertible into cash without significant discounts and valuations might become more difficult to assess with certainty.
- "Illiquid assets" have little or no secondary market trading and buying and selling such assets is difficulty and time consuming (i.e., weeks or months, rather than days), even in normal markets. Individual transactions of these assets are more likely to affect market values.

The FSB adjusts the definitions of the categories as compared to the consultation, describing rather than defining them with "indicative guidelines" regarding the liquidity of asset holdings. These revisions seem to be in response to industry comments in response to the consultation that the framework was overly prescriptive.

The FSB's revised guidelines indicate that funds could be categorized as:

Liquid: Funds investing mainly (e.g., more than 50%) in liquid assets.

Less liquid: Funds investing mainly (e.g., more than 50%) in less liquid assets.

Illiquid: Funds investing a significant proportion (e.g., more than 30%) in illiquid holdings.

In response to industry comments, the FSB acknowledges that liquidity is dynamic, but clarifies in the Final Report that fund liquidity categories are expected to be relatively static. At the time of a fund's design, redemption terms and conditions should be consistent with the fund's investment strategy and liquidity of the projected asset holdings and the categorization should be reviewed at appropriate intervals. Authorities and fund managers should seek to avoid threshold and cliff edge effects that would result from a fund moving from one category to another. The FSB also clarifies that regardless of fund category, investors should have certainty around the terms of their investment in the fund.

The FSB acknowledges that individual jurisdictions must implement and define the liquidity categories as part of their domestic liquidity frameworks and can use a range of quantitative and qualitative factors. Depending on how jurisdictions implement the FSB's recommendations, there is a risk of regulatory fragmentation.

Expectations for OEFs in the Revised Categories (Recommendation 3)

The FSB revises the expectations for funds within each of the categories regarding dealing terms and the use of anti-dilution LMTs.

Liquid Funds: In the Final Report, the FSB continues to find that daily dealing would remain appropriate for funds that fall into the liquid category. Following industry calls for additional flexibility and clarity, the FSB loosens language regarding liquid funds' adoption of anti-dilution LMTs, acknowledging that for such funds, dilution would be expected to be de minimis. In the Final Report, the FSB moderates its expectations for use of LMTs, clarifying that liquid funds only need to adopt an anti-dilution LMT "where appropriate."

Less Liquid Funds: The FSB states that less liquid funds are more likely to experience material dilution than liquid funds. These funds may offer daily dealing without notice or settlement periods if they can demonstrate to authorities that they implement anti-dilution

LMTs, or if LMTs are clearly not justified, other effective liquidity risk management measures.

Illiquid Funds: Appearing to have headed calls from central bankers to act to mitigate the risks associated with illiquid funds, the FSB Final Report continues to set the tightest expectations for these funds. The FSB finds daily dealing for these funds is inappropriate and that recommends they also implement long notice or settlement periods. In addition, the FSB continues to prompt authorities to consider restructuring the products as closed-ended funds.

Anti-dilution LMTs (Recommendations 4 and 5)

The FSB further revises its recommendations to strengthen the anti-dilution LMT framework, with the goal of mitigating potential first-mover advantage arising from structural liquidity mismatch in OEFs. The revisions seek to ensure that investors bear the costs of liquidity associated with fund redemptions and subscriptions. The FSB also aims to increase the consistency in OEFs' use of anti-dilution LMTs. The revisions to Recommendations 4 and 5 are consistent with the IOSCO Final Report and should be read in that regard.

As issued in 2017, Recommendation 4 focused on the importance of OEFs meeting redemptions under stressed market conditions. The revised recommendation, which is unchanged from the consultation, seeks to ensure that authorities make a broad set of LMTs available for use on normal and stressed market conditions.

The FSB revises Recommendation 5 to achieve greater consistency in the use of anti-dilution LMTs in both normal and stressed market conditions. In the FSB Final Report, Recommendation 5 is revised from the consultation to remove references to subscription and focus on redemptions.

While the text of Recommendation 5 is broad, the explanatory text the FSB Final Report critically notes that "financial stability risk arising from liquidity mismatch differs between OEFs."[14] Accordingly, in implementing the FSB's recommendation, authorities may distinguish OEFs on the basis of their overall liquidity mismatch profile (i.e., a fund's liquidity category) so that liquidity risk management enhancements are focused on funds with greatest risk. The FSB's expectation is that anti-dilution LMTs will be increasingly adopted by less liquid funds.

Other revisions

The FSB makes a few other changes to the 2017 recommendations. These are mostly minor and unchanged from the consultation.[15] Of note, Recommendation 2 is revised to require clearer public disclosures on the availability and use of LMTs in normal and stressed market conditions, as the FSB seeks to increase investor awareness of LMTs.

Recommendation 8 is also revised to change references from exceptional LMTs to quantity-based LMTs. This recommendation acknowledges that fund managers have the primary responsibility to consider and use these tools and other liquidity management measures but indicates that authorities should provide guidance to fund managers on their use, particularly in stressed market conditions.

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Notes

[1] FSB, Revised Policy Recommendations to Address Structural Vulnerabilities from Liquidity Mismatch in Open-Ended Funds (Dec. 20, 2023) (FSB Final Report); IOSCO, Anti-dilution Liquidity Management Tools Guidance for Effective Implementation of the Recommendations for Liquidity Risk Management for Collective Investment Schemes: Final Report (Dec. 20, 2023) (IOSCO Final Report).

[2] For a summary of the consultations, see ICI Memorandum No. 35372 (Jul. 11, 2023).

[3] ICI Global's letter to the FSB letter is available here and the IOSCO letter is available here. For a full summary of ICI Global's comments, see ICI Memorandum No. 35434.

[4] IOSCO, Recommendations for Liquidity Risk Management for Collective Investment Schemes (Feb. 1, 2018); IOSCO, Open-ended Fund Liquidity and Risk Management - Good Practices and Issues for Consideration (Feb. 1, 2018).

[5] IOSCO Final Report at 3.

[6] Id. at 26.

[7] Id. at 3-4.

[8] Id. at 28.

[9] Id. at 8-9.

[10] The IOSCO Final Report is revised to distinguish when the use of an anti-dilution LMT might be appropriate, considering the three categories of funds identified by the FSB. These categories are distinguished by liquidity of funds' assets and are described in detail below. The IOSCO Final Report is revised to focus on "less liquid funds," which IOSCO considers most to experience material dilution. IOSCO expects that such funds will increase and enhance their use of anti-dilution LMTs, in accordance with the framework set forth in the final report..

[11] Whereby a fund estimates liquidity costs by calculating the costs associated with selling a pro-rata slice of all assets in the fund's portfolio.

[12] FSB, Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities (Jan. 12, 2017).

[13] See FSB Final Report at 1.

[14] FSB Final Report at 22.

[15] The changes to the FSB's 2017 recommendations are described in the FSB Final Report at 13 and Annex 2.