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ESMA Publishes Consultations on Liquidity Management Tools

[35773]

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TO: ICI Members
ICI Global Members
Europe Regulatory and Policy Committee SUBJECTS: Alternative Investments
Disclosure
Fees and Expenses
Financial Stability
Fund Governance
International/Global
Money Market Funds
Portfolio Oversight
Recordkeeping
Risk Oversight RE: ESMA Publishes Consultations on Liquidity Management Tools

Background and Overview

On 8 July, the European Securities Market Authority (ESMA) issued two consultations regarding liquidity management tools (LMTs) with proposed regulatory technical standards (RTS) and guidelines for Undertakings for the Collective Investment in Transferable Securities (UCITS) and Alternative Investment Funds (AIFs) (the Consultations).[1] Comments are due by 8 October 2024, and ICI plans to submit a response.

The Consultations seek to implement the recent revisions to the UCITS and AIF Managers Directives (the Directives)[2], which entered into force on 16 April. The Directives require UCITS and AIFs to select and implement at least two LMTs and money market funds (MMFs) to select at least one LMT from the following list:

1. Redemption gates
2. Extensions of notice periods
3. Redemption fees
4. Swing pricing
5. Dual pricing
6. Anti-dilution levies

7. Redemptions in kind

In addition, the Consultations cover temporary suspensions of subscriptions and redemptions, which the Directives separately require all UCITS and AIFs to implement. Fund managers also have the option to implement LMTs beyond the minimum requirements and the Consultations cover side pockets, one such tool.

Building on the definitions of the LMTs in the Directives, the draft RTS cover the characteristics of nine LMTs and the draft Guidelines address the selection, activation, and calibration of each. In addition, the Guidelines address general principles, governance, and disclosures relating to LMTs. With very limited exceptions, the proposals are the same for UCITS and AIFs and ESMA asks for feedback whether this is appropriate.

ESMA expressly affirms and incorporates the recent guidance from the International Organization of Securities Commissions as well as the revised Financial Stability Board (FSB) recommendations on anti-dilution LMTs for open-ended funds (OEFs),[3] prioritising alignment of the draft RTS and proposed Guidelines with these global standards.

The draft RTS and proposed Guidelines set out a detailed set of considerations for fund managers for the selection, activation, deactivation, calibration, and governance of LMTs. With this granular approach, ESMA seeks to ensure that fund managers incorporate LMTs within their greater liquidity risk management frameworks and thus in a fair manner for all investors.

As discussed more fully in the sections below, key components of ESMA's approach include the following:

- While ESMA affirms that fund managers retain responsibility for implementing LMTs and liquidity risk management more generally in the best interests of investors, the draft RTS and proposed Guidelines would significantly limit the discretion of fund managers to do so through a combination of extremely granular considerations and prescriptive requirements.
- When selecting and implementing at least two LMTs, fund managers should consider selecting one quantitative-based LMT and one anti-dilution LMT.
- Anti-dilution LMTs should impose 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.
- Fund managers would be required to prepare a detailed LMT Policy describing the selected LMTs, calibration methodology, and activation and deactivation conditions as well as documenting, reporting, and disclosing to investors detailed information about a lengthy list of areas identified by ESMA.

Detailed Summary of the Consultations

The sections below summarise the detailed proposals in the Consultations, addressing general LMT principles, quantitative LMTs, anti-dilution LMTs, other tools, and next steps.

General LMT Principles

The general LMT principles incorporate and seek alignment with the IOSCO Guidelines and FSB Recommendations. They address fund manager responsibilities, LMT objectives, fund characteristics relating to the suitability of LMTs, LMT policy, and disclosures to investors.

Fund Manager Responsibilities

Consistent with the Directives, the draft Guidelines and RTS confirm that the fund manager has primary responsibility for liquidity risk management, which includes the selection, calibration, activation, and deactivation of LMTs. Incorporating the IOSCO Guidance and FSB Recommendations, ESMA proposes that fund managers select tools that will be comprehensive and effective in normal and stressed market conditions but warns that fund managers should not rely solely on LMTs to manage liquidity risk. LMTs must be considered one element of a fund's overall liquidity risk management framework that is designed appropriately for the fund's structure and investment strategy.

ESMA also clarifies that activating or deactivating LMTs does not exempt fund managers from their obligations on best execution, eligibility of assets, fair valuation of assets, liquidity risk management, fair treatment of investors, and ensuring consistency between the investment strategy, liquidity profile, and the redemption policy of the fund. In addition, activation of an LMT should not impact the fund's investment objectives, policy, profile, or characteristics as stated in the fund's rules, offering documents, or instruments of incorporation.

LMT Objectives

The Directives require that LMTs be implemented in the best interest of investors and in the LMT definitions, they generally provide that LMTs should reflect or take account of the cost of liquidity. Expressly referencing IOSCO's guidance, ESMA's proposals expand this objective to further specify that LMTs should impose the estimated cost of liquidity, including explicit and implicit transaction costs with any significant market impact of asset purchases or sales to meet subscriptions or redemptions.

Fund Characteristics Relating to Suitability of LMTs

The Directives require fund managers to select and implement at least two LMTs, but ESMA goes beyond the minimum requirement and, considering FSB recommendations, proposes that fund managers consider selecting one quantitative-based LMT and one anti-dilution LMT.[4] As fund managers evaluate and select LMTs, ESMA also proposes that the suitability of LMTs be considered in relation to:

- the fund's investment strategy and investment policy;
- the structure of the fund including the duration of the notice period, lock up period, settlement period, and dealing frequency;
- the liquidity profile of the fund and its underlying assets and the fund's liquidity demands, taking into account redemptions and other potential sources of liquidity risk from the liability side of the balance sheet and the results of liquidity stress tests;
- the fund's redemption policy and characteristics of the investor base; and
- the fund's distribution policy.

LMT Policy

ESMA proposes that fund managers prepare a detailed LMT Policy, which is part of the fund's greater liquidity risk management policy, describing the selected LMTs, calibration methodology, and activation and deactivation conditions. The proposed Guidelines set forth a comprehensive and prescriptive list of areas that must be addressed in the LMT Policy, including:

- clear and objective criteria for the selection of LMTs;
- clear and objective criteria for the activation/deactivation of selected and available LMTs, including an "LMT playbook" highlighting the potential sequencing and interdependencies of selected and available LMTs;
- methodology for activation and deactivation of LMTs and calibration of selected and available LMTs;
- governance frameworks around the frequency of monitoring and reviewing the calibration of an activated LMT to ensure ongoing correctness and effectiveness;
- detailed description of senior management's role in the process, including the governing body and the staff involved in the decision making;
- role and oversight of internal control functions (risk management, compliance, and internal audit);
- management of conflicts of interests and where such conflicts cannot be avoided, how their impact is managed and mitigated in the best interest of investors;
- procedures to ensure the operational readiness and effectiveness of the manager and relevant stakeholder in the event of LMT activation;
- reporting and escalation procedures;
- assumptions related to the availability of data for activating and calibrating LMTs, their justification, and the frequency of their review;
- routine checks, including back testing, on the activation of LMTs;
- assumptions related to the availability of data for activating and calibrating LMTs, their justification, and the frequency of their review;
- procedures to ensure record keeping and record retention on the activation, deactivation, and calibration of LMTs and the reasons for activation, deactivation, and calibration of LMTs, and relevant data concerning funds, investors, historical flows, results of liquidity stress tests, and market data; and
- procedures for effective and efficient communication to investors and other stakeholders and notification to the NCA where relevant.

For anti-dilution LMTs, the LMT Policy should also document:

- the nature of costs taken into account,
- the rules regarding distribution of costs between entering, exiting, and remaining investors, and
- estimation methodology based on documented and justifiable criteria and reviewed at least every six months.

Disclosures to Investors

With regards to disclosures to investors, ESMA incorporates the IOSCO Guidance and FSB Recommendations. ESMA proposes that fund managers carefully consider the type of information and timing of disclosures so that they can balance transparency with potential unintended consequences.

Quantitative-based LMTs

Suspensions

The Directives require all UCITS and AIF managers to have the ability to temporarily suspend redemptions, repurchases, and subscriptions. Fund managers may activate suspensions in exceptional circumstances and in the best interest of investors.

The RTS describe the characteristics of the suspension tool. Upon activation, suspension must apply simultaneously to subscriptions, repurchases, and redemptions and the fund cannot be closed while this tool is active. Orders that have been placed but not executed before the suspension became active cannot be executed until the suspension is lifted and at such time, the fund must simultaneously reopen to subscriptions, redemptions, and repurchases. ESMA asks for specific feedback regarding the proposed approach as it seeks to ensure all investors are treated fairly.

The Guidelines propose that exceptional circumstances be defined as unforeseen events and/or operational/regulatory environments that impact materially on the fund's ability to carry out normal business functions and activities and which would temporarily prevent the manager to meet the funding obligations arising from the liabilities side of the balance sheet. Examples of such exceptional circumstances include:

- asset valuation difficulties;
- severe liquidity issues (e.g., due to margin calls, significant size withdrawal) where executing the sale of underlying assets could cause liquidity issues for the fund (e.g., large discounts in asset sales, large dilution of remaining investors);
- critical cyber incident that impacts on the fund, the manager and/or fund's services provider capacity to operate;
- unforeseen market closures, trading restrictions, closure of trading venues;
- severe financial and/or political crisis;
- identification of significant fraud; and
- natural disaster.

Upon activating the suspension tool, ESMA proposes that fund managers formalise a detailed LMT Plan for the future of the fund, consistent with the LMT Policy.

The activation threshold for suspensions should be determined taking into account legal and regulatory requirements and avoid a mechanistic approach so that there is an opportunity for intervention to address the exceptional circumstances. Fund managers should specify the criteria for assessing and monitoring conditions that could lead to the activation of suspensions. They should also identify the criteria for determining that the conditions have changed and the processes for deactivating the suspension tool.

Redemption Gates

The Directives define redemption gates as a temporary and partial restriction on redemptions whereby investors can redeem only a certain portion of their units or shares. In contrast to suspensions, the restrictions only apply to redemptions so the fund may remain open for subscriptions.

In the RTS, ESMA proposes that the activation threshold be set for a given dealing day, where net redemption orders are expressed as a percentage of the fund's NAV. While managers could apply the trigger at the level of individual redemption orders, ESMA proposes that such trigger be prohibited because this is likely to incentivise a first mover advantage and lead to unequal treatment of investors. For European Long-term Investment Funds, the activation threshold will be determined in upcoming Delegated Regulation.

Upon activation, the redemption gate would apply to all redeeming investors in proportion to the redemption orders. Investors may decide to cancel or execute the non-executed portions of orders on the next dealing date. Fund managers would be required to specify in advance whether carried over portions of orders receive priority on the next dealing date.

Because redemption gates are preferable to suspensions and could provide a way to avoid suspensions, the Guidelines propose that redemption gates should be considered for all funds, although where there are valuation issues, other LMTs may be preferable. ESMA reasons that all assets could potentially become less liquid during stressed market conditions so all funds could benefit from the flexibility to limit redemptions. ESMA identifies some funds that should particularly consider redemption gates including:

- Funds with strongly concentrated investor base (with the implied definition of concentration being that redemption could cause the fund liquidity issues),
- Funds holding assets that might become less liquid during stressed market conditions and/or might take longer to sell, and
- AIFs with assets that might be structurally illiquid, such as real estate and private equity.

The proposals for redemption gates differ significantly from those for suspensions, giving funds more flexibility in their implementation for institutional investors. ESMA proposes that redemption gates can be automatically or discretionarily activated when there is a significant call on a fund's liquidity and that the activation threshold should be disclosed in the fund's rules, offering documents, or instruments of incorporation. Redemption gates may be used to manage day-to-day liquidity for funds marketed to institutional investors but limited to the specially defined circumstances for funds marketed to retail investors.

The Guidelines describe several considerations for calibrating the activation threshold for redemption gates including:

- NAV calculation frequency,
- the investment objective of the fund,
- the liquidity of the underlying assets, and
- ensuring redemptions under normal market conditions.

ESMA does not propose a restriction on the maximum duration or use of redemption gates, if they are temporary. Fund managers would have discretion to determine duration and use.

Although the proposals provide significant discretion to fund managers to implement redemption gates, ESMA does ask whether more harmonisation is desirable whereby ESMA would prescribe a fixed minimum threshold and that for daily dealing funds (except exchange traded funds (ETFs) and MMFs) such threshold would be set at 5 percent for daily net redemptions and 10 percent.

Extensions of Notice Periods

The Directives define the extension of the notice periods as the extension of the minimum period appropriate to the fund for redemptions.

The RTS provide that the extension of the notice period tool does not change the legal dealing frequency or settlement period for the fund, but the extended notice period may apply for several consecutive dealing dates. ESMA prioritises equitable treatment of investors and clarifies that the same extended notice period must apply to all shareholders, including in funds with multiple share classes.

In the Guidelines, ESMA proposes that an extended notice period may be considered in both normal and stressed market conditions. ESMA recommends that all funds consider this tool but specifically recommends it for funds with liquidity that is susceptible to deterioration in stress. ESMA notes that although AIFs invested in less liquid assets such as real estate and private equity funds should already have a notice period in place that is appropriate for the liquidity of their assets in normal conditions, extended notice periods still may be appropriate for such funds in stressed periods. The Guidelines identify redemption pressures and temporary valuation uncertainty as triggers that may warrant activating an extended notice period.

ESMA recommends that fund managers consider the time to orderly liquidate assets in calibrating this tool. A critical issue is also the timing of announcing the activation of the extension and fund managers should seek to avoid doing so in a way that would drive an increase in redemptions. ESMA asks for feedback as to whether extensions of notice should be applied for pre-defined periods, particularly for UCITS, which may mitigate concerns that announcing the tool could incentivise redemptions and result in unfair treatment for investors.

Redemptions In Kind

The Directives define a redemption in kind as meeting redemptions by transferring assets held by the fund instead of with cash. Redemptions in kind are the most constrained of the quantitative based LMTs. The Directives limit the activation of this tool to meet professional investors' redemptions in a pro rata share of the assets. Professional investors may receive assets that do not correspond to their pro rata share of the holdings where the fund is solely marketed to professional investors or is an ETF that aims to replicate the composition of a particular index.

Redemptions in kind can provide a valuable tool, avoiding the sale of blocks of securities in response to redemption requests and the associated transaction costs and market impacts. ESMA cautions in the Guidelines, however, that this tool may not be appropriate as one of the two required LMTs because the potential availability is so limited.

The fund manager has the discretion to set the minimum valuation frequency to activate redemptions in kind, consistent with the disclosures on the potential use of the tool in the fund's prospectus or articles of incorporation. After activation, ESMA proposes that an independent third party provide an additional valuation of the assets that are redeemed in kind.

Anti-dilution Tools

Echoing the IOSCO Guidance and FSB Recommendations, the Guidelines propose that fund managers consider the selection of anti-dilution LMTs to mitigate material investor dilution and potential first mover advantage. While all funds could benefit from anti-dilution tools, this is identified as a particular risk for funds investing in less liquid assets or assets that can become less liquid during stress. ESMA proposes that managers consider the mechanisms of anti-dilution tools and avoid simultaneously activating certain tools that could lead to duplicating impacts or undermine broader liquidity risk management objectives.

Anti-dilution LMTs should be calibrated to set activation thresholds that avoid material dilution impact in both normal and stressed market conditions. Activating an anti-dilution LMT does not impact the manager's duty to fairly value the fund at all times, and such tools should not be calibrated in a way that artificially improves the performance of the fund.

Consistent with the IOSCO Guidance, ESMA proposes that the calibration of anti-dilution LMTs needs to be adjustable so that that the tool can reflect changing costs of liquidity. Disclosed ranges should not be considered caps or restrictions and disclosures should explicitly state that ranges may be exceeded on an exceptional basis if justified by the market conditions. The governance structures for exceedances and the factors that could drive exceedances must also be disclosed.

Starting with the IOSCO Guidance and FSB Recommendations, ESMA proposes granular requirements as to how fund managers should estimate the costs of liquidity, requiring the inclusion of explicit and implicit transaction costs, including significant market impact. In the Guidelines, ESMA describes explicit costs as generally stable in amount and quantifiable with a high level of certainty in advance, with examples including brokerage fees, trading levies, taxes, and settlement fees. Implicit transaction costs may vary depending upon such factors as the type of asset and market conditions. ESMA proposes that a reasonable input for the estimation of market impact could be analysis of previous transactions under similar market conditions, comparing the price at order placement and final execution. The Guidelines propose that implicit costs should be based, as a starting point, on a pro rata slice approach, unless this does not represent a fair estimate of the true liquidity cost. ESMA recommends using pro rata costs in stressed times when it is most relevant for mitigating the potential dilution impact on the remaining investors.

Redemption Fees

The Directives define a redemption fee to be a charge within a predetermined range that takes into account the cost of liquidity for redemptions and ensures remaining investors are not unfairly disadvantaged.

In the RTS, ESMA proposes that redemption fees be a fixed or minimally variable percentage of redemption orders. They may be expressed as a range with a minimum fee greater than 0 and a maximum fee set in accordance with transaction costs that might increase in stressed market conditions.

ESMA proposes that redemption fees are charged irrespective of the impact of other subscriptions and redemptions on the fund's net asset value (NAV). This distinguishes redemption fees from anti-dilution levies and swing pricing. Fund managers have discretion to apply redemption fees to all redemptions or only when a threshold is exceeded. The threshold may be set as a percentage of the NAV, a number of shares/units redeemed, or a combination of both. In addition, fund managers have discretion to set a single level of redemption fees or use a tiered approach to charge higher fees to larger orders.

ESMA proposes that all funds may consider redemption fees, but that this tool may be particularly appropriate for:

- funds investing in assets with fixed/transparent/foreseeable transaction costs (such as real estate agency or notary fees);
- funds investing in assets with low-variation transaction costs (such as fixed taxes and levies on real estate transactions);
- funds with underlying assets that do not have very frequent and reliable pricing sources available from different trading venues; and
- AIFs invested in less liquid assets where other anti-dilution tools might be challenging

or impossible to implement because of infrequent and limited pricing sources.

In the Guidelines, ESMA proposes that redemption fees be calibrated with a methodology that ensures the cost of liquidity is charged, including the estimated explicit and implicit costs, and disclosed in the fund documentation or prospectus. Ensuring proper coverage would involve mapping the cost of liquidity to predetermined redemption thresholds. If a manager implements a static fee, ESMA would require a provision for adjustment to reflect higher costs of liquidity or stressed market conditions. ESMA also specifically recommends that fund managers consider whether a single or tired fee is appropriate for the net fund flows.

Swing Pricing

The Directives define swing pricing as a pre-determined mechanism by which the NAV for a given dealing day is adjusted by the application of a swing factor that reflects the cost of liquidity.

ESMA proposes that after activating swing pricing, the published NAV should be the swung NAV that incorporates the swing factor. The swung NAV is to be used for all transacting investors for subscriptions and redemptions and may be negative or positive, depending upon the net difference between redemptions and subscriptions.

The RTS proposes several discretionary choices for fund managers that select swing pricing. First, they may choose between a full swing, applying the swing factor to all net activity, or a partial swing, applying the swing factor when net redemptions exceed a predetermined threshold. A fund manager may apply a tiered approach to full or swing pricing, progressively increasing the swing factor for increased redemptions and subscriptions that generate higher transactions costs and market impacts. ESMA notes that a tiered swing pricing system is essentially always activated although there is no material effect on the NAV for low level of flows.

ESMA proposes that swing pricing is appropriate for funds with assets that are actively traded with frequently updated and available trading cost information and particularly where the assets have market contingent liquidity costs. Where there is valuation uncertainty for the assets, swing pricing may be less appropriate.

The Guidelines would require fund managers to disclose information regarding the activation of swing pricing in normal and stressed conditions, but funds should not disclose the activation threshold, which could cause a first mover advantage. The Guidelines propose that the activation threshold should be dynamic, so that it can account for market conditions, and that the methodology be documented in the LMT policy.

If the swing factor applied goes beyond that disclosed in the fund's prospectus, ESMA proposes that the manager provide the national competent authority with ex-post documentation to justify use of the higher swing factor in light of market conditions.

ESMA proposes that for funds that charge performance fees, such fees should be based upon the unswung NAV.

Dual Pricing

The Directives define dual pricing as a pre-determined mechanism to adjust the NAV so that one NAV applies for subscribing investors and another NAV applies for redeeming investors. This distinct treatment of subscriptions and redemptions distinguishes swing pricing from dual pricing.

The RTS provide two methods for calculating dual pricing, which are based on IOSCO's guidance. Under the first calculation, ask prices are used to determine the subscription NAV and bid prices are used for the redemption NAV. The other method involves using a dynamic liquidity factor based on market conditions to adjust the NAV up for subscriptions and down for redemptions. Fund managers would have the discretion to determine which methodology is appropriate for the type of fund and market conditions.

ESMA proposes that dual pricing may be appropriate for funds that invest in assets with liquidity costs that are comprised primarily of the bid-ask spread, but notes that any significant impact or explicit transaction costs in addition to the bid-ask spread should be accounted for with an additional adjustment to the NAV.

Like swing pricing, ESMA proposes that dual pricing may be less appropriate where the underlying assets could be subject to valuation uncertainty. ESMA notes that dual pricing is not commonly used in most Member States, and explicitly seeks feedback about its approach from those in jurisdictions where the tool is used.

Anti-dilution Levies

The Directives define an anti-dilution levy as a fee that is paid to the fund at the time of a subscription, repurchase, or redemption, that compensates the fund for the cost of liquidity incurred by the size of the transaction and ensure that other investors are not unfairly disadvantaged.

In the RTS, ESMA proposes that anti-dilution levies are only charged where there is net capital activity of the fund, but a manager may choose to only apply the levy when a pre-determined threshold is exceeded. Anti-dilution levies are set as a percentage of the redemption or subscription order and are variable and calibrated to the fund's net flows. This contrasts with redemption fees, which are fixed/low variability and charged without regards to the fund's net flows. On a given dealing date, an anti-dilution levy is charged to subscribing investors when the fund has net subscriptions and to redeeming investors when there are net redemptions. ESMA proposes that the fund managers may charge the same levy to all subscriptions or redemptions (as appropriate on a given day). Alternatively, if the fund manager can quantify exact transaction costs for particular investors, the levy may be tailored. Considering the potential for preferential treatment for certain investors, ESMA seeks feedback regarding the implementation of anti-dilution levies for funds with multiple share classes.

ESMA proposes in the Guidelines that an anti-dilution levy can be useful for funds that invest in assets with market-contingent liquidity costs, where assets are actively traded and trading costs are generally available. Where valuation is uncertain, anti-dilution levies may be less appropriate. ESMA highlights certain funds that should consider anti-dilution levies to address risks, including funds:

- with high investor concentration with a risk that one or a few investors could fully redeem their shares at short notice;
- with significant levels of subscription and/or redemption activity that could negatively impact the fund's existing investors; and
- that invest in less liquid assets such as high yield bonds and small cap equities.

Anti-dilution levies can be activated on an ongoing basis or upon reaching a pre-defined threshold. Where the levy is always active, ESMA posits it can serve as a preventative measure against dilution risks. If an anti-dilution levy is active during normal conditions, the fund manager must be able to adapt the levy to changing market conditions to ensure the tool's effectiveness.

Given the similarities between swing pricing and anti-dilution levies, ESMA proposes that the same calibration factors be used for both tools.

Other Tools

Side Pockets

The Directives define side pockets as separating assets with economic or legal features that have changed significantly or become uncertain from other assets of the fund.

The RTS propose two potential forms of side pockets. The first is a physical separation under which some assets are transferred into a new fund and other assets remain in the existing fund. The second method is an account segregation under which the valuation issues or legal uncertainty are allocated to a dedicated share class of the fund.

In each case, the side pocket must be a closed-end fund that is managed with the objective of liquidating the "bad" assets. Investors receive shares of the side pocket on a pro-rata basis of their holdings in the original fund. In liquidation, the proceeds from the sales of assets in the side pocket must be paid to investors and is prohibited from reinvestment. A fund manager would be required to allocate a proportion of the liquid assets of the fund to the side pocket to address potential liabilities from the management of the side pocket. The rest of the fund must be managed according to the disclosed investment strategy and after the formation of the side pocket, new subscriptions and redemptions are based on the non-pocket portion of the fund.

ESMA's proposal for physical side pockets notably differs for UCITS and AIFs. Under the RTS, UCITS would be prohibited from moving "bad" assets into a new fund and leaving the "good" assets in the existing fund because the result could be bad assets in a fund that is not covered by the UCITS Directive. UCITS may only use a physically separated side pocket when:

- "good" assets are moved into a new UCITS or merged into an existing UCITS and
- "bad" assets remain in the original UCITS that is closed and liquidated.

AIFs are not subject to this limitation and would be permitted to move "bad" assets into a new fund or the opposite.

In the Guidelines, ESMA proposes that side pockets only be considered in exceptional circumstances, that is, unforeseen events and/or operational/regulatory environments that impact materially on the fund's ability to carry out normal business functions and activities. Examples of exceptional circumstances include:

- significant valuation uncertainty and/or illiquidity of a specific portion of the portfolio of the fund for which there is no active market and/or for which trading is prohibited and/or for which fair valuation is temporarily unavailable, and
- in case of fraud, financial crisis, or war affecting a particular sector or geopolitical region.

The Guidelines also propose that managers have the operational capacity and governance for side pockets and that prior to activation, managers have a formal, detailed plan.

The activation threshold for side pockets should be determined taking into account legal and regulatory requirements. Fund managers should specify the criteria for assessing and monitoring conditions that could lead to the activation of suspensions. They should also identify the criteria for determining that the conditions have changed and the processes for deactivating the suspension tool.

Next Steps

Comments on both Consultations must be submitted by electronic form by 8 October 2024. ESMA will consider the comments and finalise the RTS and Guidelines by 16 April 2025. The European Commission will then need to adopt the RTS, which will be followed by a three-month scrutiny period for the Council and European Parliament. ESMA seeks feedback regarding the length of time fund managers would need for adaptation before they apply the Guidelines, in particular for existing funds.

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Notes

[1] ESMA, Consultation Paper on the Draft Regulatory Standards on Liquidity Management Tools under the AIFMD and UCITS Directive (8 July 2024); ESMA, Consultation Paper on the Guidelines on Liquidity Management Tools of UCITS and open-ended AIFs (8 July 2024).

[2] 2024/927 Directive of the European Parliament and of the Council amending Directives 2011/61/EU and 2009/65/EC as regards delegation arrangements, liquidity risk management, supervisory reporting, the provision of depositary and custody services and loan origination by investment funds (13 March 2024). For a summary of the revisions, see ICI Memo #35523.

[3] IOSCO, Anti-dilution Liquidity Management Tools Guidance for Effective Implementation of the Recommendations for Liquidity Risk Management for Collective Investment Schemes: Final Report (20 December 2023) (IOSCO Guidance); FSB, Revised Policy Recommendations to Address Structural Vulnerabilities from Liquidity Mismatch in Open-Ended Funds (20 December 2023) (FSB Recommendations). For a summary of these reports, see ICI Memo #35575.

[4] Anti-dilution LMTs include redemption fees, swing pricing, dual pricing, and anti-dilution levies. Quantitative LMTs include suspensions, redemption gates, and extension of notice period. Other tools include side pockets. Redemptions in kind are inconsistently referred to as either quantitative or other LMTs.