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BVI[1] position on IOSCO's revised recommendations for liquidity risk management for collective investment schemes

We take the opportunity to present BVI's views on the consultation report of IOSCO's revised recommendations for liquidity risk management for collective investment schemes, which sets out proposals for revisions to the IOSCO's 2018 "Liquidity Recommendations" taking into account the revised FSB policy recommendations to address structural vulnerabilities from liquidity mismatch in open-ended funds and IOSCO guidelines on anti-dilution tools (ADT) from December 2023.

> ***Q1**: Are the identified common components of OEF's structure including notice periods, lock-up periods, settlement periods and redemption caps accurately described? Are there any relevant additional considerations when setting the notice periods, lock-up periods, settlement periods or redemption caps?*

It is not entirely clear to us how the liquidity management tools (LMTs) mentioned here relate to specific recommendation 3 and the bucketing approach proposed there. In particular, these LMTs differ significantly from those mentioned in recommendation 6 (e.g. recommendation 6 does not provide for lock-up periods). More consistency should be established between the recommendations.

In any case, we have fundamental reservations about recommendation 3 and the associated explanations. These interfere with the fund managers' discretionary freedom by defining overly detailed recommendations for analysing the liquidity of assets and for using specific LMTs. We see a risk that the management company may not be able to react appropriately to market changes. It is of utmost importance that any guidance on liquidity management of open-ended funds (OEFs) considers that managing liquidity risks needs to be observed in the overall context of the individual fund's portfolio including the investment objective, the investment instrument, redemption terms and investor base. All of these issues have a different effect on the liquidity. In particular, investment funds can compensate outflows with inflows and vice versa.

First of all, the European legislator has already done its homework with the latest AIFMD review amending the Directive for alternative investment fund managers (AIFMD) and the UCITS Directive, after which the management company has a variety of LMTs available from which he can choose himself. It is therefore not acceptable that the well-functioning European regulatory system will be overloaded with new and different rules just because other jurisdictions are maybe not able to establish adequate rules or monitor compliance with these rules and therefore individual cases arise that may have an impact on the financial market in certain countries. It is also important to consider the particularities of the individual countries in the distribution of funds and their investor structure. This can vary from country to country and therefore require different measures.

[1] BVI represents the interests of the German fund industry at national and international level. The association promotes sensible regulation of the fund business as well as fair competition vis-à-vis policy makers and regulators. Asset managers act as trustees in the sole interest of the investor and are subject to strict regulation. Funds match funding investors and the capital demands of companies and governments, thus fulfilling an important macro-economic function. BVI's 115 members manage assets of EUR 4.4 trillion for retail investors, insurance companies, pension and retirement schemes, banks, churches and foundations. With a share of 27%, Germany represents the largest fund market in the EU. BVI's ID number in the EU Transparency Register is 96816064173-47. For more information, please visit www.bvi.de/en.

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Overall, we welcome the FSB's and IOSCO's policy work made in 2023 in light of further developments in open-end fund liquidity management. We also recognise that the FSB has significantly revised its final recommendations compared to the summer 2023 consultation process. These final recommendations and IOSCO guidelines correct the supervisors' initially hard line on the use of anti-dilution tools (ADTs). In particular, the FSB and IOSCO no longer require that all OEFs use at least one ADT. Nevertheless, the FSB is sticking to its bucketing approach of categorising OEFs into "liquid", "less liquid" and "illiquid" based on certain factors, which essentially focus on the liquidity of their assets without taking into account the overall liquidity profile of the fund, which includes not only the liquidity of the assets, but also the investor base and their request for return, individual features of the fund, or constantly changing market conditions. Even if national circumstances are to be given more consideration in each case, which gives the competent authorities greater discretion, we continue to maintain our previous criticism[2] of the basic concept of the bucketing approach. This can lead to the management company being expected to use a certain LMT, even if this is not in the best interests of investors. It also means that funds often have to change the LMTs they use when market liquidity temporarily deteriorates.

In particular, the new definition of 'liquid assets' as part of the new bucketing approach leads to undesirable effects and does not reflect any vulnerabilities from liquidity mismatch in OEFs. According to the proposed revised recommendation 3 and its explanations, liquid assets should be defined as assets that are readily convertible into cash without significant market impact in both normal and stressed market conditions. Such an approach mixes the question of whether an asset could be qualified as 'liquid' with the question of how high the 'liquidity risk' can be under normal and stressed market conditions which must be part of an appropriate liquidity risk management process for each OEF. To the extent that the IOSCO includes 'stressed market conditions' in the definition of 'liquid assets', there will no longer be a fund that can be qualified as investing in liquid assets. This is because liquidity of assets can also be volatile, especially in stressed times, and can lead to an asset that is basically classified as liquid today would have to be qualified as illiquid - this was historically even the case for US Treasuries or German Bunds. Therefore, the European UCITS brand would no longer be able to be classified as a liquid fund under this definition because the eligible assets could (theoretically) no longer be defined as assets that are readily convertible into cash without significant market impact in stressed market conditions. Instead, the UCITS Directive refrains from defining what is liquid, but rather defines the 'liquidity risk' as the risk that a position in the fund portfolio cannot be sold, liquidated or closed at limited cost in an adequately short time frame and that the ability of the fund to comply at any time with the redemptions at the request of any unitholder. This definition of liquidity risk is then supplemented by measures, techniques, tools and arrangements that enable liquidity risk of the fund to be assessed and monitored under normal and stressed market conditions including through the use of regularly conducted stress tests. We therefore expressly request that the focus in liquidity management be placed on the liquidity risk of the fund rather than solely on the liquidity of the assets.

It should also be noted that liquidity management under stressed market conditions is also assumption dependent. The overall liquidity of the fund therefore depends not only on how liquid the assets are, but also on the extent to which investors redeem their units. Fund's redemptions typically comprise only a (minimum) portion of the fund volume. Therefore, a 100% (or at least 50%) liquidity match is not necessary and consequently not in the interest of investors.

[2] Cf BVI position on FSB consultation report on addressing structural vulnerabilities from liquidity mismatch in open-ended funds – revision to the FSB's 2017 Policy Recommendation.

Moreover, the FSB/IOSCO 2023 recommendations do not sufficiently consider the investor base as a key criterion for the liquidity profile of the fund. It is common standard and required in the EU that the manager has to monitor the liquidity profile of the fund's portfolio of assets, having regard to the marginal contribution of individual assets which may have a material impact on liquidity, and the material liabilities and commitments, contingent or otherwise, which the investment fund may have in relation to its underlying obligations. For these purposes the manager shall also take into account the profile of the investor base, including the type of investors, the relative size of investments and the redemption terms to which these investments are subject. Therefore, it cannot be ignored that an OEF with a limited number of investors who cooperate with the manager concerning intentions to subscribe and redeem units or shares of the fund must be treated differently from those where the investor structure is more comprehensive and not known down to the last link (such as OEFs offered to a wide range of retail investors). We therefore see the need to distinguish between OEFs distributed to either retail or institutional investors. The same applies, for example, to funds with a restricted group of investors and a long-term investment horizon, in which an early exit has an economically disadvantageous effect on the investor and thus a sudden increased return demand, which the manager is confronted with, is not to be expected.

***Q2:** Are there any other key considerations related to the availability and use of anti-dilution LMTs, quantity-based LMTs and other liquidity management measures under normal and stressed market conditions?*

As a main principle, the manager should decide which of the LMTs is the most appropriate given the individual fund's portfolio including the investment objective, the investment instrument, redemption terms and investor base.

In this context, we would like to point out that the proposed categorisation of the individual LMTs into ADTs, quantity-based and other measures is not expedient in practice. Rather, the manager should have a variety of LMTs at his disposal from which he can then choose appropriately. Categorising LMTs and then trying to assign them to certain fund types (liquid, less liquid or illiquid) restricts managers too much in making the right decisions in the best interests of investors in certain market phases.

Regardless of this, we also object at this point to the approach proposed by IOSCO as early as 2023 for taking into account implicit and explicit transaction costs when using ADTs, transferred into **recommendation 7** of the consultation report. In particular, the detailed approach including also the significant market impact as part of the implicit costs is far too broad. At present, we do not have any information on the effort that the assessment of such 'significant market impact' entails in practical implementation. In any case, IOSCO's proposals do not appear practicable, firstly with regard to the procurement of (external) data and the associated costs, and secondly with regard to the effect on the liquidity costs. In general, a rather general approach should be used without any claim to 100 per cent accuracy. In Germany, for instance, we have implemented a more general approach: the swing factor takes into account the transaction costs caused by an excess of redemption or issue requests. The swing factor is determined by the management company depending on various parameters (e.g. taking into account transaction costs, bid/offer spreads, market price impact).

The implementation of ADTs such as swing pricing and anti-dilution levies is very complex and will not only lead to an administrative burden with very limited benefits during financial crises. Using these tools will also cause disproportionately high costs. In particular, this involves extensive transaction cost controlling. For this purpose, the company needs an overview of the development of market prices in the respective asset classes in order to be able to derive comparisons (e.g., bid-ask spreads). This data must largely be purchased externally from expensive market data providers, which will lead to a large cost factor in view of the current licencing and price structure. It is therefore likely that smaller companies will no longer be able to afford the implementation of such tools. IOSCO should also be aware that the mandatory approach of considering these costs will lead to a further thinning out of asset managers which would also increase concentration risk among asset managers, thereby also increasing systemic risks instead of reducing them. Moreover, competition will be limited in the long run. Undesirable side effects can occur: The investor is overprotected against risks that he is aware of and deliberately takes, but has to pay a lot of money for the respective tools and no longer has a choice between products and managers.

Q3: Are there any other LMTs or liquidity management measures commonly used by OEF managers?

We refer to our answer to Q1. We are missing the **lock-up periods** listed under recommendation 3 here.

In practice, there are cases (particularly for funds with illiquid investments) in which **funds have to suspend redemptions but remain open for subscriptions**. The reason for this is that these funds regularly need more time to sell the illiquid assets. In the meantime, they only have the option of generating additional liquidity through further subscriptions of units or shares. This would benefit all investors because dilution stemming from the potential selling of assets could be reduced or avoided. An obligation to suspend redemptions and subscriptions at the same time would therefore impair the ability to create the necessary liquidity in funds suffering from temporary liquidity problems. As the suspension of redemptions and subscriptions at the same time is a significant intervention for investors, practicable solutions should be sought in the interests of investors. This is because these types of funds could not only be temporarily suspended because - especially in stressed market phases (as the current difficulties in the real estate market show) - a sale of assets can last for more than a year. As a result, these fund types would regularly run into liquidation, which could be avoided if additional liquidity could be created through further subscriptions.

***Q4**: Have the proposed changes covered all the essential elements regarding liquidity risk management governance arrangements in relation to the use of liquidity management tools and other liquidity management measures? Are they proportionate to the differing size and complexity of responsible entities' fund ranges?*

We have no further comments on this. Here, too, we refer to the governance processes already established and functioning very well in the EU, which are set out in the AIFMD and UCITS Directive.

***Q5:** Please describe any material factors of the liquidity risk management governance and oversight arrangements which have not been included.*

We have no further comments on this.

***Q6:** What information can (and should) be disclosed to investors or the public, and within what timeframe should this information be disclosed to enhance transparency when responsible entities activate quantity-based LMTs or other liquidity management measures?*

Any guidelines on disclosure should be principle-based and only explain how the tool works, without giving specific guidance on the individual measures. In particular, a distinction must be made between the information that should be available to investors in advance (e.g., in the investment terms and conditions or the prospectus) and the information that should be available afterwards (e.g., in the annual report). In the first case, the information should contain which LMTs are already implemented in the fund, how they work and what impact they have on the investors. The annual report could then inform the investors whether and to what extent the LMTs were activated or used.

In any case, the publications should not contain any information on the liquidity category of a fund. In addition, no capitalisation thresholds or factors should be published in order to avoid potential advantages or arbitrage opportunities for certain investor groups (e.g. informed institutional investors).

Furthermore, there should be no ex-post publication requirement on the use of LMT in the past.

Q7: *Do you have any comments on any of the other Proposed Revised Liquidity Recommendations put forth in this document?*

We refer to our position paper to the FSB and IOSCO and request that the aspects mentioned therein be given due consideration.