# Liquidity risk management tools in open-ended funds

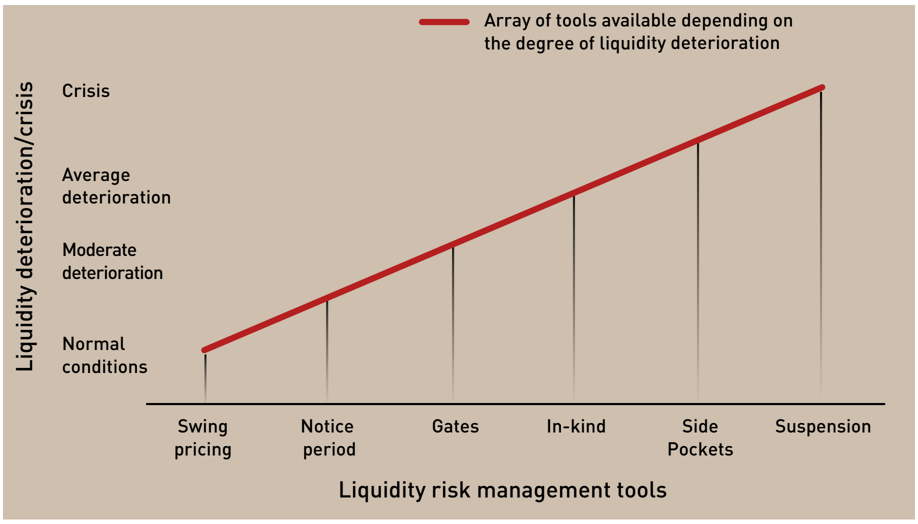
Liquidity risk management is a major concern for asset managers, particularly in the context of open-ended funds, in terms of ensuring the liquidity disclosed to investors in accordance with the fundamental principles of equal treatment of investors and market integrity.

On the asset side, even if a presumed hierarchy of liquidity exists among the various asset classes, liquidity is not naturally attached to one asset class or another. The relative liquidity of assets can vary over time, affecting the cost or the time needed to liquidate the position held in the portfolio, and can sporadically be reduced or even disappear in case of a serious liquidity crisis in a given market segment. Liquidity is a dynamic and relative notion.

Liquidity risk management implies analysing the degree of liquidity of the managed portfolio in view of its investors' side. In the sole interest of unitholders and to ensure their equal treatment, coupled with the need to preserve market integrity, the ability to activate tools to protect investors in case of a deterioration in market liquidity is now considered essential. Regulators around the world have begun work to assess the availability at the legislative level of these techniques and tools used by managers.

The proposal is to list here the following mechanisms currently available for French funds, whether UCITS or AIFs: swing pricing and anti dilution levies (ADLs), notice period, redemption gates, in-kind redemptions, "side pockets" and temporary suspension of redemptions. These techniques are often used in different situations depending on the degree of liquidity deterioration (cf. indicative only graph below).

Liquidity risk management tools




## 1. Swing pricing and anti dilution levies (ADLs)

These two mechanisms are used to provide similar protection for investors in collective investment scheme (CIS) against the negative impacts of movements in liabilities produced by subscribing and redeeming investors. The goal is to reduce the portfolio restructuring cost related to subscriptions and redemptions for the investors remaining in the fund.

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Swing pricing entails increasing or decreasing directly the net asset value, while for ADLs, the adjustment is made to the fee amount. The adjustment will be made upward or downward based on the net balance of the subscriptions and redemptions so that the costs are borne by the investors responsible for the movements that triggered these trading costs.

This technique can be applied from the first euro, but is usually applied with a trigger threshold. In this case, called "partial swing pricing", the mechanism is activated only if the net change in liabilities exceeds a predefined threshold and applies, of course, to all the assets. Different upward and downward thresholds may be used and can be expressed as an amount, a number of units or a percentage of the assets. The AFG strongly advises member asset management companies not to disclose parameters that are too detailed and recent to avoid reducing the effectiveness of this system. In particular, the management company should not disclose (in writing or verbally) the current levels of the trigger thresholds and should ensure that the internal information channels are limited in order to maintain the confidentiality of this information and avoid any misuse. However, the adjustment made to the net asset value, called "swing factor" and expressed as a percentage of the net asset value calculated as before the swing pricing is applied, may be disclosed. To ensure flexibility and security, a procedure that defines the rules for modifying the application parameters should be implemented. There must also be a procedure regarding potential conflicts of interest.

This tool is a first line of defence against a limited reduction in liquidity in the underlying markets. It is not meant to be the sole mechanism for responding to a severe liquidity squeeze. Nevertheless, it helps reinforcing investor fair treatment by encouraging the individual allocation of costs to subscribing or redeeming investors rather than the indiscriminate pooling of costs among all investors. According to usage statistics, the implementation and activation of this tool improves the medium- and long- term performance of management vehicles that have used such a mechanism by "neutralising" in the net asset value the negative impacts related to subscriptions and redemptions.

## 2. Notice period

The principle of a notice period imposed on investors who wish to redeem their shares is to allow the asset manager to obtain the liquidity needed to pay for the redemptions under better conditions. This gives the management company a period of time (specified in the prospectus) between the order cut-off date and the trade date which allows it, when necessary for certain positions that are less easily liquidated given market conditions at the time of the redemption, to organise the orders in the market so that it can dispose of the assets under the best market conditions. There are two types of notice period: mandatory and incentive. Currently, the AMF framework allows open-ended funds (excluding funds of alternative funds and retail investment funds, which have access to the mandatory notice period) to use an incentive notice period, i.e. redemption requests are either honoured without fees after the application of a notice period or without a notice period (but with a penalty in exchange).

## 3. Redemption gates

In case of a deterioration in the liquidity conditions of a CIS's underlying assets, a redemption gate can be used to temporarily spread out redemption requests over several net asset values if they exceed a certain pre-defined level.

This mechanism is one of several tools for managing liquidity risk in the sole interest of investors, provided it is stipulated in the fund legal documents[1]. In fact, in a liquidity situation that does not justify a complete suspension, it may be more in the interest of investors and market integrity to spread out redemption requests temporarily. The introduction of an option to spread out redemptions provides no information as to the probability that this mechanism will be used during the life of the fund, but mainly allows asset managers to plan ahead and have the broadest, most appropriate array of tools possible in order to manage more effectively in the sole interest of investors.

Gates are now authorised in French open-ended vehicles, either with specific schemes (that pre-exist those allowed by the "Sapin II" Law of 9 December 2016) or with a general scheme ("Sapin II" Law)

1. Adding the option to gate redemptions in an existing CIS requires the authorisation of the AMF.

requiring the existence of exceptional circumstances to activate the mechanism. The AMF specified the terms of implementation in March 2017.

With respect to the general scheme, the AMF requires transparency[2] regarding the operation of the redemption gate in the fund legal documents, with an indication of the trigger threshold, the maximum duration of the gate and the method of handling the unexecuted part of the initial order (carry-forward or cancellation, at or not at the unitholder's discretion).

More specifically, since redemption gates may be introduced only on a temporary basis in open-ended funds, the management company must provide a maximum duration for applying the gate. This duration must be justified with respect to the frequency of the fund's net asset value calculation, its management strategy and the liquidity of the assets and, in all cases, must not exceed the maximum durations specified by the AMF. Specifying a maximum duration for exercising the option to gate redemptions allows French funds to compensate for the lack of priority of redemption orders in case of a carry-forward (to discourage "lining up in the queue" and increasing pressure on liabilities) by giving redeeming investors visibility regarding the maximum period to be paid. It is a protective measure for investors in French funds in comparison with schemes that exist in other countries.

## 4. In-kind redemptions

The payment of in-kind redemptions entails delivering securities rather than cash to redeeming investors. In this way, the fund transfers the responsibility of disposing of a portion of the overall portfolio to redeeming investors, which eliminates the costs related to obtaining liquidity in less liquid or illiquid markets. It is an attractive mechanism in that it gives investors who are capable of managing the securities themselves an additional option, but is therefore not well-suited to retail investors.

Currently, for French open-ended funds, this type of arrangement is available only during the liquidation phase and only if investors have agreed to it.

## 5. "Side pockets"

When certain assets are difficult to value and dispose of in the market or are distressed, having the ability to create a segregation mechanism called a "side pocket" may be useful. The fund is then split in two, with liquid assets that can be valued on one side, and the "side pocket" containing the illiquid/distressed assets intended to be sold at a later date under the best market conditions and in the best interest of investors on the other side. The liquid portion will continue to be managed as usual, with the same NAV frequency and subscription/redemption conditions, while the "side pocket" portion will no longer allow subscriptions or redemptions and will be managed strictly in run-off mode.

This exceptional measure ensures investor fair treatment, since only those who are investors on the split date will be given a portion of the "side pocket"; whether they remain or redeem, they will retain it until the final disposal of the assets (run-off management).

## 6. Suspension

The suspension of subscriptions and/or redemptions of a CIS is a tool that should be used only in very exceptional cases, as a last resort, given its consequences. This mechanism, expressly provided for in the UCITS Directive and extended by French law to all open-ended funds, allows maintaining investor fair treatment in very difficult market situations, for example when it is not possible to dispose of assets. This mechanism also protects potential investors, who risk paying an estimated price that does not reflect reality in the event that no reliable valuation methods are available (for example, no effective listing).

2. Transparency does not include knowledge of liabilities. In fact, as is the case when swing pricing is used, investors must not have knowledge of the probability of a gate being triggered, which implies that the management company "*must observe the strictest confidentiality regarding the level of subscription and redemption orders*". (cf. *AMF Instruction on the Conditions for setting up redemption gate mechanisms - DOC-2017-05*)

This was the case, for example, when the US stock markets closed after 11 September 2001, which warranted the suspension of European funds exposed to these markets in order to prevent unit trading based on very uncertain price estimates and in the total absence of underlying liquidity resulting from the closing of markets.

Giving fund managers access to all these tools is essential for managing a potential liquidity gap between funds and underlying assets in collective portfolio management. Investors must now be convinced of the effectiveness of these tools, which are designed to both protect their interests by maintaining fair treatment and guarantee financial stability and market integrity.



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