SEPTEMBER 2023

AFG RESPONSE TO CONSULTATION PAPER

Response to the IOSCO consultation report on Anti-dilution Liquidity Management Tools

AFG

Investing in tomorrow together

The AFG federates the asset management industry for 60 years, serving investors and the economy. It is the collective voice of its members, the asset management companies, whether they are entrepreneurs or subsidiaries of banking or insurance groups, French or foreigners. In France, the asset management industry comprises 700 management companies, with €4600 billion under management and 85,000 jobs, including 26,000 jobs in management companies.

The AFG commits to the growth of the asset management industry, brings out solutions that benefit all players in its ecosystem and makes the industry shine and develop in France, Europe and beyond, in the interests of all. The AFG is fully invested to the future.

RESPONSE TO THE IOSCO CONSULTATION REPORT ON ANTI-DILUTION LIQUIDITY MANAGEMENT TOOLS

Chapitre I - Proposed Guidance 1 – Overall Framework

Q1: To what extent does the proposed guidance 1 help responsible entities to better integrate the use of anti-dilution LMTs within their existing liquidity risk management framework? Have all the critical elements been captured?

AFG response

AFG would like to remind that our members evolve in a jurisdiction that already applies the IOSCO's Recommendations. In order to share best practices regarding the liquidity risk management process, AFG has issued a Guide to explain how to build an efficient risk control framework : https://www.afg.asso.fr/afg-document/guide-professionnel-guide-pratique-de-mise-en-conformite-du-dispositif-dencadrement-du-risque-de-liquidite/

AFG has always been engaged in helping asset managers to implement sound liquidity risk management, including but not limited to the use of LMTs (including anti-dilution LMTs). AFG has regularly issued guidance on these tools:

https://www.afg.asso.fr/afg-document/les-outils-de-gestion-du-risque-de-liquidite-dans-les-fonds-ouverts/

Accordingly, AFG welcomes the proposed guidance and agrees that LMTs (including anti-dilution ones) are only one part of a broader liquidity risk management framework of the asset manager..

One of the critical elements that helps estimating the redemption magnitude is a more accurate knowledge of the liability side. AFG would like to recall that the industry urges regulators to oblige fund distributors and intermediaries to provide them with the most granular and updated profile of investors' typologies for each fund. This typology should be provided on a free-charge basis to fund managers. This more granular typology of fund end-investors would strongly facilitate their fine-tuned anticipation of redemptions in case of market stresses. Authority intervention in this matter is necessary, as leaving this issue at bilateral negotiation level has shown no major improvement on this subject.

Q2: Do you agree with the proposed guidance 1 regarding the inclusion of anti-dilution LMTs within the daily liquidity risk management framework that OEF managers should have in place at all times?

AFG response

According to its guide on liquidity risk management compliance, AFG fully agrees that the anti-dilution LMTs may form a key part of the daily liquidity risk control framework for selected categories of funds. The inclusion of those tools does not mean that they are as effective for all types of funds nor that they have to be activated on a continuous basis.

To quote IOSCO document (p 20) : *while proper procedures are expected to be put in place to enable the use of anti-dilution LMTs as part of the ongoing liquidity management, such LMTs are not necessarily expected to be activated at all times.*

Instead of mandating the use of anti-dilution LMTs for all OEFs, IOSCO should ask that managers regularly update their fund cartography so as to justify when funds do not need such tools, like this can be the case for large cap equity funds.

Q3: Is this proposed guidance appropriate for all types of OEFs in its scope, and proportionate for all types of responsible entities to implement? If not, please explain.

AFG response

All LMTs are not as effective for all types of OEFs, including anti-dilution LMTs. Anti-dilution LMTs and especially swing pricing and ADLs are considered equivalent to a refining of the fund's valuation and accounting rules for underlying assets. The efficiency of using anti-dilution LMTs is thus linked also to the valuation policy and the impact of using the LMT as regards the current asset valuation. Thus, funds investing in small/mid caps, convertible bonds, high yield bonds, etc. are more likely to make an efficient use of swing pricing than equity funds invested in large listed caps. Anti dilution tools may thus not have additional value for funds with extremely liquid assets.

In addition, anti dilution tools appear more suited to some liquid strategies than to certain OEFs invested in less liquid, unlisted assets due to valuation reasons.

Proposed Guidance 2 – Types of Anti-Dilution LMTs

Q4. Has the proposed guidance identified all of the anti-dilution LMTs commonly used by responsible entities? Are there any other LMTs that share the same economic objective of passing on the liquidity cost to transacting investors, that could be included in this guidance? If so, please describe them.

AFG response

AFG believes that the guidance has identified the usual anti-dilution LMTs but would like to remark that the proposed list includes tools that are not mentioned in the coming updates regarding LMTs in the european regulations. More precisely, regarding the next AIFMD/UCITS release and ESMA's proposals on ELTIFs redemption policy rules, only 3 LMTs (swing-pricing, anti-dilution levies and subscription/redemption fees) are listed.

AFG members do not see other LMTs to include.

Q5. Are the identified anti-dilution LMTs described correctly? Do the features or characteristics of the different tools vary or do they generally operate as described ?

AFG response

In principle yes. It should be added that funds can also be valued at bid pricing instead of mid pricing and this constitutes an antidilutive tool that discourages redeemers and encourages subscriptions, especially in difficult / bear markets.

Q6. Do you support the proposed guidance 2? If not, in which cases do you think it could be justified not to adopt at least one anti-dilution LMT in OEFs (other than ETFs and MMFs)? What elements do you take into consideration to choose a specific anti-dilution LMT for your OEFs ?

AFG response

All LMTs are not as effective for all types of OEFs, including anti-dilution LMTs. Anti-dilution LMTs and especially swing pricing and ADLs are considered equivalent to a refining of the fund's valuation and accounting rules for underlying assets. The efficiency of using anti-dilution LMTs is thus linked also to the valuation policy and the impact of using the LMT as regards the current asset valuation.

AFG believes that funds investing in very liquid asset classes (such as "blue chip" equity) may not need to rely on specific mechanism to ensure a fair treatment of the investors. Anti-dilution tools may thus not have additional value for such funds (investing in extremely liquid assets)

Model asset pricing also may not be suited easily to apply tools like swing pricing, but more some sort of NAV discounts.

Funds investing in small/mid caps, convertible bonds, high yield bonds, etc. are more likely to make an efficient use of swing pricing than equity funds invested in large listed caps.. AFG thus believes that anti-dilution tools should rather be implemented with liquid asset classes that can have wider bid-ask spreads at times (credit, HY, small cap, convertibles).

Regarding funds investing in unlisted assets, anti-dilution tools do not appear suited due to valuation reasons. Moreover, when the redemption frequency is low or when notice period are long enough, adopting anti-dilution LMT is not always justified.

AFG would also like to mention that anti dilution mechanisms such as swing pricing have a cost of implementation and a cost of operation, and can also generate operational risk, in particular in the process of NAV calculation.

It they were forced to implement anti-dilution LMT, Smaller asset manager which do not have the IT resources to develop highly industrial processes may bear a disproportionate cost compare to the added value of the LMT in certain cases. Our opinion is that in the cases where the mechanism advantages are not considered significant (i.e. for funds invested in large cap equities) regarding the cost and risk of the mechanism, the asset manager shouldn't be forced to include them systematically.

On conclusion , the selection of LMT pertain to the investment and structuring strategies and the asset management company should have the primary responsibility and are best place to implement and justify their LMT selection policy.

Proposed Guidance 3 – Calibration of Liquidity Costs

Q7. Have the components of the cost of liquidity, as described above, captured all the relevant costs that should be considered when calibrating anti-dilution LMTs?

AFG response

AFG disagrees with the definition of the cost of liquidity where the only choice is to simulate the buy/sell of a pro-rata slice of the portfolio. We acknowledge the fact that the approach can seem consistent, but the estimation process should be based on the transactions that the portfolio manager intends to actually perform, when it is possible to do so.

[Typically, when the fund's manager decides to take the opportunity of redemption orders to raise the leverage of the fund, he could use the liquidity buffer (or draw from a credit line). In that case, no transaction will occur. Accordingly, no transaction costs should logically be passed on the redeeming investors.]

Regarding the components of the cost of liquidity, AFG considers that the proposed list is comprehensive. Please see hereafter the current calculation/estimation methods in France for swing pricing (they work very well). The current flexibility should be kept.

"The estimated cost of readjusting the portfolio is calculated based on the net balance of subscriptions and redemptions.

This readjustment cost may reflect the following:

- Transactions actually undertaken in connection with subscriptions or redemptions;
- A theoretical investment or disinvestment in proportion to existing assets in the portfolio;
- A theoretical investment or disinvestment in proportion to the fund's benchmark.

The management company may base its calculation of this portfolio readjustment cost on costs (transaction fees, bid-ask spreads, taxes, settlement charges) by asset class, market segment (country, sector, maturity), type of instrument or security. It should establish these parameters either daily or periodically, such calculation period not exceeding six months. Cost estimates must be documented and based on justifiable data. Furthermore, estimated liquidity costs must take into account the fund's valuation policy (mid or bid price).

Q8. How does the cost of liquidity vary across different funds ? To what extent could we achieve a more consistent approach to calibrating anti-dilution LMTs for similar funds, and what is the best way to do so?

Q9. How can significant market impact be incorporated in the calibration of all of the proposed anti-dilution tools? Please provide examples.

AFG response

AFG also fully agrees on the necessity to include market impact on the calibration and share the view of IOSCO on the fact that the assessment is difficult to achieve. It is often not possible to achieve a precise calibration because the prevailing market interests for each instrument can change rapidly.

Consequently, this assessment exercise should be conducted with pragmatism and flexibility in order to avoid a useless "usine à gaz".

Some concrete examples can be found in the French doctrine: https://www.afg.asso.fr/wp-content/uploads/2020/12/guidepro-swingpricing-eng-201207web-1.pdf

Funds are collective investment vehicles where investors collectively bear the usual cost of liquidity. AFG believes anti-dilution tools cannot prevent totally and perfectly from the dilution effect. Accordingly, it is fundamental to accept that anti-dilution LMTs are here to prevent only from material dilution. Hence, the accuracy of the assessment exercise and the liquidity costs allocations should be commensurate with the current conditions and market data availability.

It is useless to require a too high accuracy level and will not prevent motivated investors from redeeming the units/shares.

Q10. Can all of the components of the cost of liquidity (i.e., explicit and implicit transaction costs including any significant market impact) be incorporated in all five anti-dilution LMTs as set out in the discussion of Element (i) above? If not, what are the limitations to doing so and how would you suggest improving the effectiveness of these anti-dilution LMTs?

AFG response

AFG response

AFG fully supports the view of IOSCO that no cap or limit should be applied due to the assessment of the cost of liquidity, such restrictions would prevent anti-dilution LMTs from achieving their objectives of passing the prevailing liquidity costs to the redeeming investors.

The cost of liquidity depends on several elements, as the size of the deal, the time to sell the position, the type of market order, the relative need to sell the asset compared to other assets in the portfolio (at the level of the portfolio), etc.

The elements to be taken into account (estimating the total cost arising from subscriptions and redemptions) are described as per the previous question.

Q11. To what extent can a subscription / redemption fee achieve the objective of addressing the investor dilution issue and financial stability concern of OEFs by attributing the liquidity costs to transacting investors? How could it be appropriately calibrated to achieve this objective?

AFG response

AFG considers that subscription/redemption fees can be seen as a simpler form of anti-dilution levy. This tool may suffer from a lack of flexibility. The amount of these fees is usually capped by the maximum rates disclosed in the prospectus. They can be changed at any time, but the new value must be communicated in a timely manner to the fund administrator in order to be applied for the next NAV.

Consequently, the adjustment can only occur before knowing the net outflow or inflows. This constraint limits the accuracy of the liquidity costs assessment.

However, this can be useful to adopt when setting up ADLs is not technically possible.

Degressive redemption fees are essential to ensure notably in semi-liquid funds that clients have the incentives to remain invested.

In addition, a degressive redemption fee over time is an important element of the product design and should be left to the discretion of the AM

Q12. Do you see benefits in a tiered approach to attributing the cost of liquidity by using different adjustment factors according to net fund flow, market conditions and characteristics of the funds? Are there any operational difficulties? Any further comments thereto?

AFG response

This is an interesting feature but implemented in a few cases to our knowledge. Operationally, it is a more complicated option for the ecosystem (depository, fund administrator). The tiered approach should be an option for the asset manager.

Q13. How could guidance on LMT calibration achieve a fair balance between (i) ensuring investors have a clear expectation of the cost of liquidity they could be charged and (ii) ensuring responsible entities have enough flexibility to attribute the overall cost of liquidity at all times, especially under stressed market conditions?

AFG response

We concur with the FSB and IOSCO views that estimates should be on best effort basis, with continuous improvement and under strong supervision of the fund's management, through the oversight of the liquidity policy. Swing/ADLs are not a cost per se, they are equivalent to a refining of the fund's valuation and accounting rules for underlying assets. It is an adjustment to the valuation, not a "cost". The valuation is dependent on the market conditions and investors are subscribing and redeeming at unknown NAV (the next NAV calculation). The risk sections of the fund documents explain already the risk of change in value for units invested in underlying markets.

Q14. Is the proposed approach regarding ranges of liquidity cost adjustment appropriate? If not, how could it be improved?

AFG response

This proposal seems to be too complex. Ther should be no mandatory approach. The investment manager should bear the flexibility not to disclose parameters.

Q15. Is the proposed expectation on the level of confidence and the sophistication of liquidity cost estimations appropriate? If not, how could it be improved?

AFG response

A too sophisticated approach can be counterproductive. Swing pricing worked well during the Covid-19 crisis and having the flexibility to take the appropriate decisions in a very short timeframe is one of the most useful characteristics of a swing used in stresses market conditions. Relying on a strong back testing framework seems to be reasonable.

Proposed Guidance 4 – Appropriate Activation Threshold

Q16: What are the appropriate factors to consider in setting the activation threshold so that anti-dilution LMTs will be activated for any subscription / redemption activities with material dilution effect? How would you define 'material dilution effect'? Why and how could it vary across different funds?

AFG response

The overall judgment-based approach appears to AFG members the most appropriate (not to have too low thresholds to avoid too frequent activations).

Q17: Does the use of an activation threshold introduce the risk of trigger / cliff-edge effects? How could trigger / cliff-edge effects be avoided? Could the tiered swing pricing address the trigger / cliff-edge effect?

AFG response

In order to avoid trigger/ cliff-edge effects, it is key to not disclose too much detail on calibrations and notably the thresholds should not be communicated in order not to be front-runned.

According to the French market practice/doctrine, the asset manager « should not disclose parameters that are too detailed and recent so that to enable an investor to amend his/her subscription or redemption strategy so as to take advantage of more advantageous conditions and thus reduce the Swing Pricing mechanism's efficiency. In particular, the management company does not communicate (in writing or orally) the current levels of the trigger thresholds. To this end, it notably ensures that the internal circuits of information are restricted to favour the conservation of the confidential character of this piece of information. »

A tiered approach may have anti-cliff edge effects if and only if the thresholds are not disclosed, as per the previous paragraph's explanation.

Proposed Guidance 5 – Governance

Q18: Do the proposed arrangements discussed above include all the essential elements regarding governance and oversight arrangements in relation to the use of anti-dilution

AFG response

LMTs? Are they proportionate to the differing size and complexity of responsible entities' fund ranges?

Q19: Please describe any material factors of the governance and oversight arrangements which have not been included.

AFG response

Proposed Guidance 6 – Disclosure to Investors

Q20: Is the ex-ante information described above likely to be appropriate and effective in explaining the use of anti-dilution LMTs to investors? What other information about dilution, if any, might be helpful to investors before they invest in a fund?

AFG response

We believe that the detail of information as described in p.26 is much too granular and the disclosure to investors should be of a higher level principle-based nature. The asset manager should have the flexibility to decide if swing factors are disclosed or not ex-ante and if any swing factor range is given in the prospectus or not. An ex-post average information on the previous year (on the website) is a fair information to give with no risk of front-running.

Q21: What information can (and should) be disclosed ex-post to investors or the public, and at what frequency, to enhance transparency without compromising the aims of the anti-dilution LMTs or creating unintended consequences? Further, how soon should this information be disclosed to investors?

AFG response

An ex-post average information on the previous year (on the website) is a fair information to give with no risk of front-running. A 4/6 months delay to the financial year end seems acceptable.

Q22: Are there other risks than those described in this section attached to the disclosure of the parameters used for anti-dilution tools?

AFG response

AFG members believe that arbitrage risk, performance blurring and investor protection appear as the main risks.

Overcoming Barriers and Disincentives

Q23: Do you agree with the list of barriers and disincentives identified? Do you consider there are others that are not covered?

AFG response

We agree with the various barriers listed in the consultation paper. Most important one remains the capacity of market infrastructures and participants to deal with significant volumes, which is clearly not the case today (often mainly manual processes).

Distributors should also be mentioned. In France, retail distribution is often processed through unit-linked account. Accordingly, LMT should be replicated at the unit-linked level which is not always the case.

It would be helpful if FSB and IOSCO could give more specific recommendations in this respect.

Q24. In your view, what are the most significant barriers or disincentives to the implementation of anti-dilution LMTs? What are your suggestions for possible solutions to mitigate or overcome the barriers and disincentives to the implementation of anti-dilution LMTs?

AFG response

Q25. For those OEFs facing significant barriers, what are the implications for their ability to implement this guidance? Are adjustments needed to the guidance to account for this, bearing in mind the objective to mitigate dilution for investor protection?

AFG response

Other questions

Q26. Do you have any other comments on any guidance proposed in this document?

AFG response

We welcome the objective of greater and more consistent use and availability of anti-dilution tools in the funds' market as they can bring substantial value to investors and the economy as a whole.

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