



OICU-IOSCO

IOSCO Guidance on Anti-Dilution Liquidity Management Tools

IOSCO and FSB Open-Ended Funds Consultations Launch Event
12 July 2023



OVERALL FRAMEWORK FOR THE DESIGN AND USE OF ANTI-DILUTION LIQUIDITY MANAGEMENT TOOLS (LMTs)

- All open-ended funds (other than ETFs and MMFs) should consider and use at least one anti-dilution LMT as part of their daily Liquidity Risk Management framework
- Objective: to mitigate investor dilution and potential first mover advantage arising from structural liquidity mismatch in OEFs
- How: by imposing on subscribing and redeeming investors the estimated cost of liquidity
- 5 Elements of these framework:
 - Types of anti-dilution LMTs
 - Appropriate calibration of liquidity costs
 - Appropriate activation thresholds
 - Governance
 - Disclosure to investors

TYPES OF ANTI-DILUTION LMTS

- Tools that adjust or are implicit in the Net Asset Value:
 - Swing pricing
 - Valuation at bid or ask
 - Dual pricing
- Tools that add/deduct a fee to/from the Net Asset Value
 - Anti-dilution levies: variable fees according to liquidity cost
 - Subscription/redemption fees

CALIBRATION OF LIQUIDITY COSTS

- Estimation of the transaction costs to buy/sell a pro-rata slice of the portfolio
 - Exception for cases where using a pro-rata approach to estimate the transaction cost is not possible, e.g., a significant proportion of AUM in inherently illiquid assets, such as real estate and private equity
- All transaction costs to be included:
 - Explicit costs: brokerage fees, trading levies, taxes, settlement fees
 - Implicit costs: bid/ask spreads, significant market impact
- Significant Market Impact
 - Price movement originated by a relatively large transaction in relation to the immediately available market liquidity
 - Managers to use their best efforts to make estimates based on analysis of previous transactions

CALIBRATION OF LIQUIDITY COSTS (CON'T)

- In principle, there should not be any caps or restrictions that prevent anti-dilution LMTs from achieving this objective. Therefore, the calibration of anti-dilution LMTs should be adjustable when needed, even if a normal range of adjustment factors/fees is disclosed or set
- Independently of the anti-dilution LMT chosen, responsible entities should be able to demonstrate to authorities that the calibration of the tool is appropriate and prudent under normal and stressed market conditions

APPROPRIATE ACTIVATION THRESHOLD

- Anti-dilution LMT should be activated to avoid any material dilution impact in the fund
- Different practices:
 - Single pre-determined activation threshold and factor
 - Tiered approach: multiple pre-determined activation thresholds and factors
- Important to minimise the risk of trigger/cliff-edge effects
- Ongoing review of the appropriateness of the activation threshold; e.g., during market stress, the threshold may be reduced to zero

GOVERNANCE

- Governance: Clear decision making processes for the use of anti-dilution LMTs
 - Governance committee
 - Adequate skills, knowledge and data
 - Review (back testing) and escalation processes
 - Oversight by senior management or Board
 - Role of depositary and external auditor

DISCLOSURE TO INVESTORS

- To better inform investors how LMTs are designed and will be used, to help them to internalise the cost of liquidity within their investment decisions...
- ... while avoiding providing so much information that investors may front run/game the activation of anti-dilution LMTs
- Liquidity cost to be charged to investors could be higher than the value disclosed in the documentation under stressed market conditions
- Questions around the ex-post information to be disclosed to investors and the timing of that disclosure

OVERCOMING BARRIERS AND DISINCENTIVES TO IMPLEMENTATION OF ANTI-DILUTION LMTS

- Negative Perceptions
 - Reputational concern due to additional cost perceived by investors, and increased fund price volatility
- Market-wide structural and operational barriers
 - Operational costs related to the development of anti-dilution LMTs
 - Increased operational risk due to the lack of operational readiness of third parties, such as, fund administrators or accountants
 - Need for substantial reconfiguration of current distribution and order-processing practices to have reliable net fund flow data
 - Lack of relevant data such as reliable bid-ask spread information

OVERCOMING BARRIERS AND DISINCENTIVES TO IMPLEMENTATION OF ANTI-DILUTION LMTs

- Potential solutions
 - Includes a suite of five different anti-dilution LMTs that responsible entities may choose from
 - Does not prescribe a specific calibration for each anti-dilution LMT nor does it specify which tool should be used or when
 - Provides for best efforts estimation of the cost of liquidity, including market impact, as well as variation in the degree of sophistication of the estimation
 - Adoption of at least one anti-dilution LMT by all fund managers and enhancement of investor disclosures should alleviate negative perceptions
 - Further investor education on the role of anti-dilution LMTs
 - Closer communication with intermediaries and service providers to design anti-dilution LMTs to enable effective implementation

Thank you