Liquidity Management in Investment Funds – Global, UK and EU Regulatory Developments and Practical Considerations

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Global and EU Regulatory Developments

For a number of years, liquidity risk in investment funds has been under heightened global regulatory scrutiny. In light of the unprecedented growth of the asset management sector and increasing holdings of less liquid assets by the Collective Investment Schemes (CIS), global regulators have undertaken a series of steps aimed at increasing information and transparency to both authorities and investors with respect to open-ended funds, strengthening liquidity risk management frameworks and practices and further enhancing investor protection.

In 2017, in its **Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities**, the Financial Stability Board (FSB) highlighted liquidity mismatch between fund investments and redemption terms and conditions for open-ended fund units as one of the top systemic risks.[1] A number of high profile fund suspensions in the UK and the EU (see sidebar) have further underpinned regulators' focus on fund liquidity management.

2016 – a number of UK property funds suspended in the immediate aftermath of the UK Referendum on the EU Membership due to high level of redemptions

2019 – Woodford fund in the UK suspended due to inability to meet investor redemptions, and is currently being wound up

December 2019 – amid Brexit extension and UK general elections, a leading UK commercial property fund suspended due to high level of redemptions

January 2020 – two Irish property funds gated due to a rise in redemptions

March 2020 – sharp increase in volume of investor redemptions in certain types of funds amid COVID-19 pandemic; over 70 funds suspended across the EU

In response to the FSB's policy recommendations, in 2018 IOSCO published its principles-based final report on **Recommendations for Liquidity Risk Management for CIS**.[2] Notably, in addition to the systemic risk perspective, IOSCO also incorporated the investor protection considerations, pointing out that that "effective liquidity risk management is important to safeguard the interests and protection of investors, maintain the orderliness and robustness of CIS and markets, and helps reduce systemic risk, all of which supports financial stability." In its final report, IOSCO outlines the following additional recommendations to its original 2013 report[3]:

- underlying liquidity should be considered throughout the entire life cycle of the fund, including at the initial design/pre-launch stage (Recommendation 4)

- additional liquidity management tools can be used to limit, or manage, redemption rights in instances of stressed market conditions, as appropriate and in compliance with applicable laws (Recommendation 4 – 3rd section, Recommendation 12 and Recommendation 17)

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1 Source: https://www.fsb.org/2017/01/fsb-publishes-policy-recommendations-to-address-structural-vulnerabilities-from-asset-management-activities/
2 Source: https://www.iosco.org/library/pubdocs/pdf/IOSCOPD590.pdf
3 Source: https://www.iosco.org/library/pubdocs/pdf/IOSCOPD405.pdf

- disclosure to investors should include periodic information regarding the relevant fund's liquidity risk as well as information on the general approach that the CIS will take in distressed situations (Recommendation 7)

- reasonable efforts to understand one's investor base and its historical redemption patterns should be made in order to build realistic stress scenarios (Recommendation 13)

- further guidance is given in relation to stress tests; scenarios should include both backward looking and forward looking hypothetical scenarios; they should be based on reliable and up-to-date information and could include various risks and factors such as credit rating downgrades or reputational risks (Recommendation 14)

- contingency plans should be established and periodically tested, to ensure any applicable liquidity management tool can be used when necessary, in a prompt and orderly manner (Recommendation 16)

In its report, IOSCO set out its expectation that securities regulators would actively promote the implementation of its recommendations taking into account the specific legal structures and prevailing market practices, local conditions and circumstances in each jurisdiction. It is anticipated that IOSCO will at some point assess implementation of its recommendations across the relevant jurisdictions.

In the EU, in September 2019 ESMA responded to the recommendations from the European Systemic Risk Board (ESRB) by **publishing its final guidelines regarding liquidity stress testing (LST) of investment funds**[4] – applicable to Alternative Investment Funds (AIFs) and Undertakings for the Collective Investments in Transferable Securities (UCITS). The LST guidelines apply from September 30, 2020, to fund managers, depositaries and national competent authorities (NCAs). ESMA noted that the purpose of the guidelines is to increase the standard, consistency, and frequency of liquidity stress testing already undertaken and to promote convergent supervision of liquidity stress testing by NCAs. More specifically, ESMA guidelines require fund managers of AIFs and UCITS to:

- stress test the assets and liabilities of the funds they manage at least annually, though the guidelines recommend that it is done quarterly

- have strong understanding of the liquidity risks arising from the assets and liabilities on the fund's balance sheet so the LST employed is appropriate for the fund it manages

- document LST in an LST policy within the UCITS's Risk Management Process or the AIF's Risk Management Policy (RMP) – the guidelines set out a series of matters which should be included in the policy

- properly integrate and embed LST within a fund's risk management framework and subject to appropriate governance and oversight

- when seeking fund authorisation from an NCA, be able to demonstrate that the fund can remain sufficiently liquid during normal and stressed conditions

[4] *Source*: *https://www.esma.europa.eu/sites/default/files/library/esma34-39-882_final_report_guidelines_on_lst_in_ucits_and_aifs.pdf*

- depositaries must have appropriate verification procedures to check that a manager has documented LST procedures in place

More recently, in February 2020, ESMA also announced the launch of **a Common Supervisory Action on liquidity risk management by UCITS managers**[5] whereby NCAs are required to request quantitative data from UCITS managers in their respective EU Member States, to be followed with in-depth supervisory analyses on a sample of UCITS managers and UCITS. NCAs are also expected to share best practices during the process through ESMA. Reportedly, a number of NCAs (including Commission de Surveillence de Sectuer Financier (CSSF) in Luxembourg and Central Bank of Ireland (CBI)) have completed initial data collection from funds with specific liquidity profiles and are in the process of carrying out data analysis, the results of which will be then shared with ESMA. According to ESMA, in light of the high profile liquidity stress episodes discussed earlier and depending on the outcome of this Common Supervisory Action, ESMA may decide to feed the findings into a more fundamental revision of the UCITS framework and also inform the AIFMD review.

United Kingdom, Luxembourg and Ireland Developments

In the UK and across the EU Member States, national regulators have been adopting global guidelines as well as implementing local measures to enhance investor protection in the context of investment fund liquidity.

United Kingdom

The FCA has been working on enhancing its rules in the aftermath of the UK referendum on EU membership in June 2016, when a number of property funds had to suspend dealing temporarily when they encountered difficulties in valuing assets in uncertain markets and meeting shareholder redemptions as a result of many investors simultaneously trying to withdraw their money at a short notice.

FCA's **Policy Statement 19/24 on Illiquid Assets and Open-Ended Funds** was published in September 2019. It applies from September 30, 2020, although the FCA indicated that in-scope firms should consider the principles ahead of that date. The rules are designed to reduce potential for harm to investors in funds that hold illiquid assets (such as property), particularly under stressed market conditions, and require funds to suspend dealing where valuations are uncertain; introduce improvements to the quality of the liquidity risk management and depositary oversight; and apply certain mandatory disclosure requirements.

On November 4, 2019, UK FCA wrote to the boards of the UK fund managers to remind firms of its expectations regarding liquidity management and portfolio composition. This was followed by two sectoral 'Dear CEO' letters for mainstream[6] and alternative asset managers in January 2020 in which the FCA stated that liquidity management remains a key supervisory priority. Furthermore, the regulator reiterated that ensuring effective liquidity management in funds is a central responsibility for fund managers and it remains their responsibility even if they delegate investment management to another person.

The UK Financial Policy Committee (FPC) has also been conducting a piece of work and, on December 16, 2019, published the initial findings of the **FCA's and the Bank of England's joint review of liquidity risks in open ended investment funds.**[7] The FCA is now expected to issue

[5] *Source : https://www.esma.europa.eu/press-news/esma-news/esma-launches-common-supervisory-action-ncas-ucits-liquidity-risk-management*
[6] *Source: https://www.fca.org.uk/publication/correspondence/asset-management-portfolio-letter.pdf*
[7] *Source: https://www.bankofengland.co.uk/financial-stability-report/2019/december-2019*

wider liquidity management rules for UK investment funds following the conclusion of the work carried out by the FPC. The FCA is also monitoring the outcome of ESMA's Common Supervisory Action discussed earlier.

More recently, in March 2020, UK FCA's Director of Markets and Wholesale Policy delivered a speech to the members of the UK Investment Association on open-ended funds investing in illiquid assets.[8] In addition to the update on its policy work related to liquidity management, the FCA highlighted that swing pricing and notice periods can help protect fund investors and reduce risks to the wider financial system when there is pressure to sell fund assets to meet redemption requests. The FCA also invited the UK's asset management industry and stakeholders to comment on the best mix of tools to ensure open-ended funds appropriately manage liquidity risks while enabling investments that can benefit shareholders and the wider economy.

Luxembourg

In December 2019, the CSSF published its **Circular 19/733**[9] to implement the 2018 IOSCO Recommendations for Liquidity Risk Management for CIS. In the Circular, CSSF notes that it expects in-scope entities (Luxembourg fund managers, all Luxembourg undertakings for collective investment (UCIs) and those involved in the operation and supervision of such undertakings) to implement IOSCO Recommendations and draw on good practices.

Ireland

In August 2019, the CBI issued a **communication to fund management companies**[10] reminding them of the importance of ongoing, effective liquidity management and emphasising compliance with legislative and regulatory obligations for UCITS and AIFs. In particular, CBI's expectation is that the Board, relevant directors and designated persons should, on an ongoing basis, assess the liquidity position of each fund under management, ensuring that the liquidity of the investment portfolio remains in line with the respective fund's redemption policy while taking into account investors' potential redemption demands.

Regulatory Response to COVID-19

In response to COVID-19, regulators have been taking steps to support the financial services sector in dealing with the impacts of the pandemic while also ensuring investor protection.

Given increased market volatility amid the COVID-19 pandemic, in March 2020 CSSF implemented a specific monitoring of the largest fund managers whereby they have to notify the CSSF of significant developments and issues including any daily redemptions exceeding 5% of the fund NAV and any weekly redemptions above 15%. Subsequently, CSSF further extended the scope of this requirement to a wider number of Luxembourg fund managers.[11]

Additionally, in April 2020 CSSF confirmed that UCIs using swing pricing as an anti-dilution mechanism can increase the swing factor beyond the maximum swing factor laid down in the prospectus in certain situations.[12] As required by CSSF, revised swing factors must be

[8] *Source:* https://www.fca.org.uk/news/speeches/open-ended-funds-investing-less-liquid-assets
[9] *Source*: https://www.cssf.lu/en/document/circular-cssf-19-733/
[10] *Source*: https://files.simmons-simmons.com/api/get-asset/Liquidity_Management_Brexit_Letter_August_2019.pdf?id=bltda5d470246121a45
[11] *Source*: https://www.cssf.lu/en/2020/05/launch-of-the-ifm-notification-on-fund-issues-and-large-redemptions-via-edesk/
[12] *Source*: https://www.cssf.lu/wp-content/uploads/FAQ_Covid_19_eng.pdf

communicated to investors and the decision must duly justified and take into account the best interest of the investors.

In Ireland, in its April 30, 2020 letter to investment funds and management companies, CBI reiterated that in the context of the market conditions amid the impact of COVID-19, it expects that effective liquidity management includes an assessment as to whether a UCITS or AIF has appropriate liquidity management tools in place. CBI also highlighted the importance of clear and effective communication to investors on liquidity management tools, including updates to the relevant fund documentation.[13]

Regulatory authorities elsewhere have also initiated changes designed to improve liquidity management and/or improve supervisors' ability to manage systemic risk. Amendments to the German Capital Investment Code (Kapitalanlagegesetzbuch – KAGB) in March, 2020 set new rules in relation to redemption gates and swing pricing. The UK FCA has also enhanced reporting from depositaries focusing on fund flows and heightened borrowing or where depositaries are aware funds are experiencing liquidity stress and/or difficulties in valuing assets.

Liquidity Management Tools (LMT)

There are a number of liquidity management tools generally available to fund managers across different types of funds (subject to adequate disclosure in fund prospectus, notification to the regulator[14], fund board approval and timely notification to the investors), in particular when facing stressed market conditions and/or trying to manage increased investor liquidity demand:

- **Redemption fee/anti-dilution levy / swing pricing**

  All three approaches look to protect longer term investors from the costs of shorter term divestments. In order to protect the remaining investors from absorbing the full costs of the asset sale, the fund may decide to apply an additional redemption fee to cover the costs of the sale of the underlying assets to meet investor redemptions. This can also be achieved via an Anti-Dilution Levy (ADL) which is typically deployed to defray costs associated with large investor subscriptions or redemptions. The fund may decide to deploy swing pricing, whereby the fund would move from a mid NAV pricing basis to either a bid NAV or offer NAV basis depending on whether it's a net inflow/outflow in the fund. All three mechanisms are supported by J.P. Morgan in its role as a Fund Administrator, with swing pricing being the most common tool utilised by fund manager clients, in particular during periods of market volatility.

- **Deferred settlement**

  It is possible that, in certain market conditions, a deferred settlement may be an option for the fund. The fund manager may decide to temporarily align investor dealing settlement to settlement of the underlying assets held by the fund by extending the shareholder settlement timeline (e.g., move from the typical T+3 shareholder settlement cycle to a longer cycle). This requires a significant amount of coordination between the fund manager, shareholders, transfer agent and potentially fund accountants. Depending on the option chosen, respective systems may need

[13] *Source: https://www.centralbank.ie/docs/default-source/regulation/industry-market-sectors/funds/industry-communications/industry-letter---measures-related-to-investment-funds-in-light-of-ongoing-market-uncertainty-due-to-covid-19.pdf?sfvrsn=2*

[14] *Depending on the scenario and individual circumstances, regulatory approval may be also required*

reconfiguration to change the settlement basis of fund and/or manual intervention may be required to put processing of shareholder deals on hold until such time that the settlement timelines of the shareholder dealing and underlying fund assets can align. For daily dealing funds with high volume of shareholder activity and complex distribution chains, this may not be the most viable solution.

- **Fund suspension**

  Where appropriate, a fund manager may decide to suspend shareholder dealing in the fund for a period of time.

  However, depending on the size of the fund Assets Under Management (AUM) and in the event of further deterioration in market conditions, the fund manager may decide that the best course of action is for the fund to cease trading immediately and liquidate proceeds to the underlying investors.

- **Redemption in-kind**

  In this scenario, an institutional investor wishing to redeem fund shares would agree with the fund manager that, rather than taking cash proceeds from the redemption, they would take assets to the equivalent value of their current holding. For funds and their service providers, this would be managed on a tailored basis similar to how in-specie transfers into the fund are managed.

- **Side pocket**

  Side pocket is a mechanism that can be employed by open-ended AIFs (and UCITS in limited circumstances) to separate illiquid and hard-to-value assets from other more liquid assets. In a side-pocket scenario, non-performing assets are moved into a separate account and the corresponding increase/decrease in value is ring-fenced to investors who are already in the fund at the time of the move. A side pocket generally requires approval from the regulator and a notification to the shareholders. If this is not already permitted in the fund constitutional documents, these materials will need to be updated.

- **Partial gating**

  Partial gating could be considered by fund managers where daily net shareholder redemption requests exceed a certain percentage of the fund NAV, for example 10%. In a partial gating scenario, shareholder redemption orders are not fully paid out on fund settlement date and may be paid out in tranches over several days (maximum of 14 days as per the UCITS directive). In this case, it may take several days for the fund to entirely fulfil shareholder redemptions requirements depending on the cash liquidity level of the fund. Any unfulfilled portions of shareholder redemptions are carried into the next available dealing cycle.

  Depending on the sophistication of the underlying distributors' and transfer agent's platforms, there may be no systemic solution available: therefore, applying partial gating may require a return to fully manual processing of shareholder dealing. As typical straight-through-processing (STP) levels for shareholder dealing are generally at 90% or above across the industry, risks associated with breakage of STP levels and implications for the wider fund distribution chain are among key considerations for fund managers before deciding on usage of partial gating. Fund's dealing frequency

and shareholder dealing volumes are also among key factors when deciding whether partial gating is appropriate. For example, it would be more suited for funds with infrequent and low volume of shareholder dealing than for funds with daily or intra-day dealing and high volumes of shareholder activity.

When invoking partial gating, fund managers should consider: timely communication with fund distributors and investors; suspension of intra-day NAVs as shareholder deals can only be processed at the end of day NAV when all redemption orders for the day are received and validated; suspension of the automated/STP processing of shareholder dealing and switch to manual environment to be able to support partial gating; increase in cash and stock reconciliation breaks; and additional processing required for fund distributors due to breakage in the distribution chain.

Based on our experience with these LMT mechanisms, detailed runbooks should be agreed between fund manager and its transfer agent and fund accounting provider prior to invoking any of these measures.

Money Market Funds

In 2018, new rules to make money market funds (MMFs) more resilient against financial market difficulties, reduce the risk of runs and limit cross-border contagion began to apply in the EU. Among key provisions, MMF Regulation introduced new liquidity requirements to ensure there is sufficient liquidity to meet investors' redemption requirements. 10% of Low Volatility NAV (LVNAV) MMF assets and 10% of Government Constant NAV (VNAV) MMF assets must be able to be repaid by the issuer within a day, with 30% repaid within a week. Variable NAV (VNAV) MMFs are required to hold at least 7.5% of assets that mature within a day and 15% that mature within a week.

Additionally, Article 28 of the MMF Regulation also requires that each MMF has in place sound stress testing processes that identify possible events or future changes in economic conditions which could have unfavorable effects on the MMF.

To support fund accounting clients who manufacture MMF with their obligations under the MMF Regulation, J.P. Morgan provides investor dealing cash flow reporting available throughout the day, with the frequency determined by client preference. This reporting allows MMF portfolio managers to have real-time transparency into the fund inflows/outflows to ensure they are meeting the necessary liquidity requirements under MMF Regulation.

J.P. Morgan also can facilitate intraday investor dealing to allow for same day settlement, in particular where a MMF may be distributed globally across multiple investor time zones. Upon request, J.P. Morgan is able to consider providing an intraday credit line to allow a client to manage their daily cash flows by facilitating intraday settlement for investor dealing, while not being constrained by their portfolio settlements to fund the respective shareholder redemptions.

Additionally, J.P. Morgan has developed reporting (available intraday or end of day) to enable clients review their different MMF structures against the liquidity thresholds to allow early identification of potential regulatory breaches.

As USD and GBP interest rates veer towards negative rates, EU MMF fund managers will be looking at their liquidity stress scenarios and the options available to them under stressed market conditions. In addition to the liquidity managements tools discussed earlier, MMF fund managers have several tools at their disposal (assuming they are clearly articulated in the fund documentation including the fund prospectus where required). The fund could:

- consider selling higher yielding assets
- consider reducing the annual management fee
- consider allocating any available realised gains to income to maintain a positive daily yield
- switch from CNAV to a VNAV (for fund that are LVNAVs operating as a CNAV) and rebase may be required if fund price basis is USD/GBP/EURO 1.00

To support clients in the context of their obligations under the EU MMF Regulation, J.P. Morgan developed runbooks to cover all of these liquidity management mechanisms. While the runbooks are broadly generic, each fund manager would need to consider all relevant aspects before deploying each one of these mechanisms, including ensuring sufficient notice is given to the fund accounting provider and the transfer agent to make appropriate systems and operational changes. The fund's board would need to approve the chosen mechanism before it can be applied to the fund.

Role of the Depositary

The depositary performs oversight of certain fund manager obligations, including ensuring that fund valuations, cash flows, and procedures for investor dealing are carried out in line with fund documentation and applicable regulations and national laws.

In respect of liquidity stress testing specifically, most respondents to ESMA's consultation on LST Guidelines[15] indicated that the depositary role should be limited to simple verification that managers have a process in place, rather than re-performing liquidity management functions or procedures. ESMA made this explicit in the final set of guidelines[16]. UCITS and AIFMD directives also confirm that liquidity management is a core fund management function.

In the UK, the FCA has imposed wider oversight obligations in respect of certain types of illiquid funds via Policy Statement 19/24[17], whereby depositaries must conduct their own assessment of the liquidity profile of such funds. This wider role defined by the FCA goes beyond the EU regulatory framework, although the incoming rules confirm it remains the depositary's obligation to oversee the fund manager process and apply an effective challenge, rather than re-perform quantitative assessments.

J.P. Morgan Depositary Services has initiated and completed a number of changes to its oversight model, including ongoing assessment of client funds and procedures, in response to regulatory and client expectations. This includes enhanced monitoring of significant fund NAV movements and verification that managers have an appropriate LST process in place.

Regulatory expectations have developed considerably following high profile fund stress events and fund suspensions discussed earlier. While J.P. Morgan continues to engage with clients, regulators and industry trade bodies to develop and enhance best practices, regulators have rapidly responded to market stress events by introducing new rules and/or enhancing existing regulatory frameworks. Clients in all locations are encouraged to engage with their depositary and regulators at the earliest opportunity where funds are facing potential liquidity stresses.

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[15] *Source*: https://www.esma.europa.eu/press-news/esma-news/esma-publishes-responses-its-consultation-liquidity-stress-test-guidelines

[16] *Source*: https://www.esma.europa.eu/sites/default/files/library/esma34-39-882_final_report_guidelines_on_lst_in_ucits_and_aifs.pdf, *Sect 103*

[17] *Source*: https://www.fca.org.uk/publication/policy/ps19-24.pdf

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