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Submitted via email to: LMTGuidanceConsultation@iosco.org – subject line: Response to LMT Guidance – Consultation Report

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RE: IOSCO Consultation Report, July 2023 "Anti-dilution Liquidity Management Tools – Guidance for Effective Implementation of the Recommendations for Liquidity Risk Management for Collective Investment Schemes." (CR03/2023)

Mr. Shanahan:

The Securities Industry and Financial Markets Association ("SIFMA")[1] and the Asset Management Group of SIFMA ("SIFMA AMG")[2] appreciate the opportunity to provide comments to IOSCO's July 2023 Consultation Report on proposed guidance for liquidity risk management tools ("LMTs") used by open-end collective investment schemes.

IOSCO's proposed guidance recognizes key design elements. In some markets, funds already have the ability and choose to make use of LMTs. IOSCO's Consultation Report recognizes some of the reasons why funds make use of LMTs. Not all LMTs are the same and not all markets can accommodate LMTs.

We believe there are also opportunities to improve the guidance and make tailored LMTs more effective and implementable. Separately, we are submitting a response to the July 2023 Financial Stability Board Consultation Report that reflects similar themes as our responses to the IOSCO Consultation.

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[1] SIFMA is the leading trade association for broker-dealers, investment banks, and asset managers operating in the U.S. and global capital markets. On behalf of our members, we advocate for legislation, regulation, and business policy affecting retail and institutional investors, equity and fixed income markets, and related products and services. We serve as an industry coordinating body to promote fair and orderly markets, informed regulatory compliance, and efficient market operations and resiliency. We also provide a forum for industry policy and professional development. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association ("GFMA").

[2] SIFMA AMG brings the asset management community together to provide views on U.S. and global policy and to create industry best practices. SIFMA AMG's members represent U.S. and global asset management firms whose combined assets under management exceed $45 trillion. The clients of SIFMA AMG member firms include, among others, tens of millions of individual investors, registered investment companies, endowments, public and private pension funds, UCITS and private funds such as hedge funds and private equity funds. For more information, visit http://www.sifma.org/amg.

I. General Observations

SIFMA and SIFMA AMG recognize the need for open-end mutual funds to effectively manage liquidity risk, material dilution risk, and act in the interest of shareholders. With the wide breadth of funds with different managers, perspectives on strategies and investment decision-making, instruments and asset classes, and shareholder bases, it is critical to allow funds to retain the ability to make investment and product design decisions for themselves.

Funds manage liquidity, transaction costs, and the risk of dilution every day. Transaction costs directly erode performance. As fund managers are primarily judged on performance by investors and Boards, the natural built-in incentives influence behavior. Likewise, funds manage liquidity risk and balance the need to meet shareholder redemptions with the desire to invest in assets that produce returns for shareholders.

Funds clearly disclose their investment objectives and provide ongoing reporting to shareholders, allowing investors to make informed decisions regarding whether to invest, how much to invest, and when to make changes. In a competitive market with a wide variety of options, shareholders make their own investing choices or rely on the assistance of financial advisors to help guide them.

If there is reason for additional regulatory measures to address liquidity and the risk of material dilution, we encourage data-driven and incremental measures that balance actual costs and potential benefits, preserves the role of the fund manager as the party best positioned to know their specific facts and circumstances, and avoids prescriptive frameworks build on estimates and data limited by artificial precision. Our thoughts and suggestions below further amplify these themes in response to questions asked in the IOSCO Consultation.

As a threshold matter, we agree that the scope of the Consultation should exclude exchange traded funds and money market funds. We also agree that the scope should be limited to public collective investment schemes rather than private fund vehicles. Private funds have very different investor profiles, use cases, distribution mechanisms, and regulatory regimes that limit public disclosure and communications.

II. Executive Summary

The following themes are woven through our responses:

- Funds and investment managers are best positioned to manage liquidity and make assessments of appropriate measures. Funds are not homogenous - "one size fits all" solutions will not effectively adapt to unique facts and circumstances.

- Any anti-dilution efforts must focus on material dilution or the risk of material dilution and should not be employed in ordinary market conditions. Anti-dilution measures must avoid becoming a penalty for those redeeming or subscribing.

- Regulatory authorities should not prohibit any credible alternatives or mandate particular measures. Funds must have latitude to assess and tailor measures considering potential benefits for shareholders and the associated costs, burdens, and challenges.

- Liquidity management tools must be operationally feasible and cost effective to implement and maintain. Simple and stable tools that use existing workflows, timelines and technology will be more feasible than complex and dynamic tools. Expensive measures will impose more costs than benefits, particularly on shareholders.

- In the absence of commonly agreed methodologies to identify and measure material dilution, any regulatory guidance or mandate must acknowledge the imprecise nature of estimates when funds seek to impose actual liquidity costs on redeeming or purchasing shareholders.

- Estimates of transaction costs via a pro-rata slice assumption might be feasible for regulators seeking a consistent or objective methodology, but any guidance should acknowledge and emphasize that such calculations are estimates with inherent limitations. Funds may not trade via pro-rata slices in practice.

- There are no credible, repeatable, and objective means of precisely measuring implicit costs through "market impact" or "slippage." The number of dynamic market factors involved – particularly for fixed-income instruments – makes such estimates inappropriate inputs for assessing actual costs to shareholders.

III. Responses to Questions

<u>Proposed Guidance 1 – Overall Framework</u>

1. **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?**

We appreciate that the proposed guidance recognizes that any anti-dilution efforts must focus on "material" dilution.[3] In the absence of consensus on identifying and measuring dilution, attempting to identify and address immaterial or de minimis dilution adds explicit cost without clear benefit to investors.

Not all asset classes and not all funds have the same transaction cost profiles. Accordingly, anti-dilution measures may not be required for all funds or, at a minimum, should be tailored for specific fund facts.

[3] See, e.g., IOSCO Consultation Report, July 2023 – Proposed guidance, Page 5: "If responsible entities set thresholds for the activation of anti-dilution LMTs, those thresholds should be appropriate and sufficiently prudent so as not to result in any <u>material</u> dilution impact in the fund" (emphasis added).

We agree with the Consultation's approach of making multiple LMT tools available. Any credible approach should not be prohibited. Any guidance regarding frameworks should avoid explicitly or implicitly mandating particular anti-dilution tools or requiring rigidity that deprives the fund necessary flexibility to adjust for their facts and as conditions warrant.

2. **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?**

We remain skeptical that all funds experience material dilution in normal market conditions. Maintaining a program to address little to no dilution in normal market conditions builds in an ever-present cost that is borne by shareholders. If funds are expected to activate measures in stressed conditions, issues of logistics and operational feasibility must be considered.

Funds are challenged to design programs that are robust enough to be credible, flexible enough to adapt to changing market conditions, operationally simple enough to administer, and beneficial enough to be welcomed by shareholders. This balancing act requires trade-offs. A solution that is easy to administer might not be precise or shareholder friendly. A solution that is dynamic and sophisticated might be difficult to administer. We urge IOSCO to augment any final guidance with latitude for funds to exercise their judgment about what is appropriate for their facts.

Any framework with the latitude to adjust depending on market conditions must be capable of administration by all parties involved (including funds and intermediaries) and capable of being conceptually explained to and understood by shareholders. Administration becomes difficult with greater complexity and variability. For example, a variable liquidity fee requires a fund to identify the need and calculate the revised fee and requires any intermediaries involved to update their systems to apply and collect the new and different fee. While a theoretical vision might suggest that precise and timely market data can drive tailored and dynamic anti-dilution measures when warranted, operational logistics make such an approach less feasible. A stable framework that is periodically revisited and revalidated is likely more operationally viable than a framework with continual changes.

These trade-offs will likely lead to different applications and measures being used by different funds in different jurisdictions with different facts. IOSCO should acknowledge that as an acceptable outcome.

3. **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.**

Maintaining a program imposes operational costs on funds and shareholders, so any measures must produce a compelling benefit that outweighs the costs. The Consultation states that "[a]s the OEF sector is very diverse, there is no "one size fits all' solution regarding liquidity risk management, including the use of anti-dilution LMTs.[4]"

[4] IOSCO Consultation Report, July 2023 at Page 9.

We agree and extend the thought to the level of sophistication and depth of the program that is necessary to address the needs for a particular fund. Funds with little to no risk of material dilution in normal or stressed markets should not expect to approach the issue in the same way or with the same commitment of staff or resources as funds with a higher probability of material dilution.

Once issued, any guidance must be applied and administered by regulators in practice by acknowledging that "one size does not fit all." Funds may apply the guidance in different and proportionate ways and should not be expected to all look and operate the same.

There are also potential for challenges presented to distributors, intermediaries and recordkeepers if different funds elect different LMT tools with different timing, technology, and workflow implications.[5] Funds do not operate in a vacuum, so the guidance or regulatory mandates need to be flexible enough to allow for consideration of such factors.

The guidance should be amended to acknowledge that LMTs may not always be practicable and that LMTs should only be necessary to address the risk of material dilution. The guidance should also remove the "first mover advantage" rationale given a lack of consensus for that as a rationale.

Accordingly Proposed Guidance 1 should be amended as shown: Responsible entities should have appropriate internal systems, procedures and controls in place, <u>where practicable and necessary to address the risk of material dilution</u>, at all times in compliance with applicable regulatory requirements for the design and use of anti-dilution LMTs as part of the everyday liquidity risk management of their OEFs ~~to mitigate investor dilution and potential first-mover advantage arising from structural liquidity mismatch in OEFs~~.

<u>Proposed Guidance 2 – Types of Anti-Dilution LMTs</u>

4. **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.**

There are variations on the LMT's identified in the proposed guidance. For example, the guidance describes "Valuation at the bid or ask prices" as a process that can switch from bid to ask price depending on the direction of net flows. Such an approach requires knowledge of net flows which has clear implications for fund distribution. In the United States, most fund shareholders invest through intermediaries and retirement platforms. These distribution arrangements prevent a fund from obtaining accurate flow information at the time and NAV is struck. Imposing a "hard close" that requires all orders to be received by the fund when it calculates its NAV could produce more

[5] IOSCO Consultation Report at Page 14, Fn22: "For example, some fund managers expressed that, when a fund is distributed by a third party (e.g., fund platform), applying anti-dilution levies may be more operationally burdensome, compared to swing pricing, because the third party would have to correct the price provided to fund investors by adding the anti-dilution levy to the fund NAV."

timely flow information, but has major adverse implications for shareholders because of the intermediary processing functions.[6]

Likewise, a fund may determine that a higher risk of material dilution exists for redemptions rather than subscriptions. Such a fund might elect to impose redemption fee but not a subscription fee.

As a general proposition, no credible mechanism should be prohibited. No regulator should define a list of permitted tools and potentially preclude a new and innovative future idea. New or different approaches ought to be feasible if they meet the same principles and policy objectives.

5. **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?**

As described in the previous response, LMTs may have variations with different features or characteristics.

Some measures may not be available to funds due to other operational, legal or regulatory dependencies involving others in the fund distribution process.

6. **Do you support the proposed guidance? 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 ?**

We support the following key principles:

- Shareholders come first. Any solution needs to be in their best interests and balance costs against benefits, avoid impairing the product or their investing experience.

- Simple and stable solutions are best.
  - Solutions must be understandable to shareholders.
  - Minimize impact on existing timelines, technology, workflows and operations.
  - Minimize impacts on distributors, intermediaries, recordkeepers and others in similar roles downstream of funds and fund decisions.
  - Solutions need to be reasonably stable over the long term. Frequent changes are difficult to administer and can cause shareholder confusion.

[6] IOSCO Consultation Report at Page 28 and 29: "In some jurisdictions, the inclusion and use of certain anti-dilution LMTs, despite their availability, may face market-wide operational barriers such as the need for substantial reconfiguration of current distribution and order-processing practices in order to have reliable net fund flow data as an input to the calculation of liquidity cost. Intermediaries may not communicate fund flows to the fund managers until after the responsible entity has calculated the NAV of the OEF, meaning that the fund managers may have to determine the NAV (including whether to apply swing pricing) before knowing the inflows and outflows with reasonable certainty. The current processes of intermediaries therefore introduce delay or complexities in implementing anti-dilution LMTs in these jurisdictions."

- Any LMT must retain a link to material dilution. A blunt tool used solely to discourage redemptions (rather than address dilution) loses credibility. Any concept to enhance dilution risk management recognizes that:
  - Funds have inherent incentives to minimize transaction costs because costs reduce performance.
  - Material dilution does not always exist.

- Funds rather than regulators are best positioned to assess dilution and tailor LMT tools for different dilution magnitudes, strategies, and shareholder bases. Keep board or other oversight body involvement consistent with oversight rather than operations.

- Chasing precision has diminishing returns. Practicable rather than certain is sufficient.
  - Reasonable methodologies for identifying material dilution and calculating fees/factors warrant good faith deference.
  - Stable fees/factors are more viable than constantly changing fees/factors.
  - Balance risks of undercharging and overcharging exiting shareholders.
  - Market impact estimates are incapable of reliable and credible models or measurements, especially when being used to calculate actual costs to shareholders.

- Stable but flexible
  - Periodically re-validate dilution assessment, measures and fee/factor calculations.
  - Retain agility to change fees and factors for significant market developments.

Not all funds require active anti-dilution programs and material dilution is not aways a problem warranting an LMT solution. We believe that regulators should defer to the judgment of the fund and manager to determine whether anti-dilution measures are necessary or appropriate for their fund and, if so, what specific anti-dilution measures are appropriate for their fund.

Factors considered by a fund could include, but are not limited to other regulatory implications, shareholder acceptance, assets, strategy, shareholder concentration, distribution (*i.e.,* implications for intermediaries and retirement platforms), practicality of implementation, availability of data, and potential benefit for the costs and burdens involved. These elements should not be a checklist but are illustrations of factors that a fund could incorporate into its considerations.

In addition to fund holdings/instruments or strategy, there are valid reasons why an LMT may not be available, reasonable, or warranted for a fund to implement. For example, swing pricing might not be viable because of unavailable timely fund flow information, liquidity fees may not be viable because the funds are wrapped into other insurance or contractual arrangements prohibiting added fees and dual NAV may not be viable because of the major operational and technology overhaul required. Bid-ask pricing based on direction of flows may not be viable because of the lack of timely flow information and market trading conventions that utilize bid-ask pricing only in certain asset classes. A fund with unconcentrated but highly liquid holdings and a diverse shareholder base that trades infrequently has a low risk of material dilution. We believe a fund should have the deference to assess its facts and options and make decisions it believes are in the best interest of its shareholders.

Costs should also be carefully considered before implementing LMTs. What are the actual costs involved to develop and maintain LMTs and do the costs outweigh the demonstrated benefits? Funds must bear costs to build out infrastructure that is ready for use when and if needed. Depending on fund design, strategy and asset classes, and market conditions, funds and shareholders could bear substantial costs for tools that are never utilized. Funds can weigh these costs and benefits in making their determinations. The significant cost, however, further argues for keeping LMTs limited in scope because not all funds require active anti-dilution programs and material dilution is not always a problem warranting an LMT solution.

The guidance should be amended to acknowledge that LMTs may not always be practicable and that LMTs should only be necessary to address the risk of material dilution. The guidance should also remove the "first mover advantage" rationale given a lack of consensus for that as a rationale.

Accordingly, Proposed Guidance 2 should be amended as shown: As part of their liquidity risk management framework, responsible entities should consider and use, where practicable and necessary to address the risk of material dilution, at least one appropriate anti-dilution LMT for each OEF under management ~~to mitigate investor dilution and potential first-mover advantage arising from structural liquidity mismatch in the OEFs they manage~~.

Proposed Guidance 3 – Calibration of Liquidity Costs

7. **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?**

We agree with the Consultation's assessment that "[i]t is difficult to quantify and determine the materiality" of a potential first mover advantage.[7] Any reasonably feasible framework must acknowledge the difficulty of calculating liquidity costs that should be charged to subscriptions and redemptions. Such costs are likely variable and require estimates and models to determine. Given the degree of inherent imprecision, if regulators attempt to require funds to attempt to make such calculations, expectations should be limited to reasonably practicable estimates.

8. **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?**

Any guidance should ensure that allocations of transaction costs are only allocations of costs and do not operate as a de facto penalty for redemptions or subscriptions. The Consultation's starting premise is that an estimated cost of liquidity should be based on a fund buying or selling a pro-rata slice of portfolio assets. However, as the Consultation rightly notes "'[t]his does not mean a fund manager will always need to buy/sell a pro-rata slice, as fund managers need to make appropriate judgements to determine what the actual trading strategy should be in the best interest of all investors as a whole."[8]

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[7] IOSCO Consultation Report, July 2023 at Page 6.
[8] IOSCO Consultation Report, July 2023 at Page 15.

Regulators may determine that such an approach is warranted. If all funds in the same market honor a similar methodology, investors and regulators get comparability and consistency. Given the difficulties of identifying and measuring dilution, assuming a common methodology is not an unreasonable approach if all parties involved recognize the limitations and nature of the results.

Fund managers do not always buy or sell pro-rata slices of every holding to meet redemptions or invest subscriptions. In fact, it may not be in the best interests of the fund and the strategy to mechanically do so. Fund managers may deem it best to sell specific holdings that are considered at or near full value or they may select representative holdings across the portfolio rather than small portions of all holdings. These approaches help minimize transaction costs and avoid odd lots, both laudable goals in the context of an anti-dilution discussion. Likewise, funds deploying cash from new subscribers may choose to make new investments based on current market opportunities rather than blindly buying small pieces of every existing holding.

A pro-rata premise implicitly accepts that calculations are rough estimates. Stipulating a pro-rata methodology may be a reasonable approach given other alternatives for regulators issuing guidance or writing rules, but should not be viewed as a precise calibration or calculation. As noted previously, measuring and quantifying material dilution is difficult. Estimates of transaction costs via a pro-rata slice assumption might be a feasible regulatory approach but any guidance should acknowledge that such calculations are, in fact, estimates. This is especially critical because the estimates are used to assess actual costs to shareholders and all parties – including shareholders – should understand that estimates and assumptions determine the amount of any anti-dilution charge.

Assuming a pro-rata buy/sell trading slice also risks producing higher transaction costs than the fund actually incurs and therefore allocates higher fees to redemptions or subscriptions than may be warranted. Funds meeting redemptions in whole or in part from cash rather than selling instruments would inevitably have lower transaction costs than result from a pro-rata assumption.

In fact, funds may hold a certain percentage of highly liquid assets precisely as a precaution to meet unexpected redemptions. In times of market stress, it is possible that funds will utilize some of these highly liquid assets to meet short-term redemption needs. By utilizing some portion of highly liquid assets, the fund avoids incurring greater transaction costs to raise cash to meet redemptions. While the fund and remaining shareholders may have a slightly less liquid profile in the short term, the fund manager balances the liquidity profile of the fund. Funds may also make use of other predictable inflows of cash that do not require asset sales, such as interest and dividends received and maturities of bonds.

We caution against presuming that any fund utilizing or selling any amount of cash or highly liquid assets in the short term inherently places remaining shareholders at a disadvantage by causing the fund to hold proportionately less liquid or illiquid assets. Holding highly liquid assets as a form of insurance requires the ability to use that insurance should the time come and may be the right course to reduce or mitigate the impact of transaction costs and forced selling in the market. We recognize that there could be scenarios where funds are not thoughtful about liquidity profiles and shareholders end up experiencing the feared results, but there should be no presumption that such scenarios are the base or universal case.

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

The IOSCO consultation defines "slippage" as an amount of liquidity taken out of the market measured by the difference between the price when an order was placed and the final execution price. "Slippage" operates on the assumption that in a stressed market, a large order may be difficult to fill and cause the transaction price to adjust to a different market clearing price than smaller orders would require.

In the fixed income market, the process of obtaining bids or offers is a negotiation. A potential trade is not necessarily executed at whatever clearing price the market happens to provide at a particular size. A trader conducts price discovery before making the decision to execute and may adjust their approach accordingly. This built-in incentive to minimize transaction costs operates at all times, including stressed markets.

Market participants may not be able to accurately and credibly identify and measure "slippage" or "market impact." While we understand the concept, we do not believe that a regulatory mechanism can credibly establish a credible, repeatable, and objective means of measuring implicit costs through "market impact" or "slippage."

The number of dynamic market factors involved makes such estimates inappropriate inputs for assessing actual costs to shareholders. This is particularly the case for fixed-income instruments where variances in bid-offer spread changes, differences based on size, and dislocations between and among sectors and sub-sectors are integral characteristics of liquidity at any point in time.

There may be cases where funds utilize estimates and models for liquidity risk management, such as assessing liquidity profiles of fund holdings or conducting stress tests. In these cases, the output is a data point for consideration by the investment professionals, not a definitive determinant of costs applied to shareholders.

In addition, the IOSCO consultation suggests making a slippage assessment before the purchase or sale, assessing the materiality of the impact, and then incorporating into an LMT according to a pre-set framework. In times of market stress where volatility is high, liquidity limited, and price discovery is challenging, it would add friction to the trading process to require each fund manager to conduct such an assessment for each trade and the results might be questionable. Even if data is available in stressed markets, it would likely be infused with best guesses and estimates.

If the starting point of determining transaction costs assumes a pro-rata slice, the resulting costs are estimates rather than precise calculations. We appreciate the Consultation's faith that fund managers will be able to identify and refine market impact calibrations over time with more experience, but we question the marginal benefit of attempting to seek greater precision.

10. **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?**

The IOSCO consultation outlines five LMT varieties. Valuation at bid or ask prices depending on net flows and dual NAV pricing are both based on bid and ask market data. Neither requires the fund to estimate and assess a transaction cost to be imposed in the form of a swung price, anti-dilution levy, or liquidity fee.

Adding further adjustments on top of market-derived bid and ask assumes that the market-derived data does not capture the full magnitude of transaction costs. As noted above, we question the marginal benefit of attempting to identify and calculate significant market impact costs in real-time.

11. **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?**

As noted above, any guidance should ensure that allocations of transaction costs are only allocations of costs and do not operate as a de facto penalty for redemptions or subscriptions. It is possible that a reasonable solution might allocate transaction costs while having no impact on investor redemption behavior in stressed markets. Any guidance should recognize the need for right sizing cost allocations. "Conservative" estimates or calculations will unfairly charge transacting shareholders more than is warranted on grounds of cost allocation.

We also question whether similar approaches are warranted for both redemptions and subscriptions. While redemptions carry the weight of a calendar in terms of a fund needing to send cash to departing shareholders, subscriptions have no such timing pressure. Fund managers are incentivized to deploy the fund's assets prudently and decisions about cash utilization and timing are within their prerogative and may not cause the same types of transaction costs involved in selling assets in a stressed market to meet unexpected redemptions on a set time schedule. Funds should have the option to apply to subscriptions but there should be no regulatory mandate.

12. **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?**

As noted above, any framework with the latitude to adjust depending on market conditions must be capable of administration by all parties involved (including funds and intermediaries). Administration becomes difficult with more complexity and variability. For example, a variable liquidity fee requires a fund to identify the need and calculate the revised fee and requires any intermediaries involved to update their systems to apply and collect the new and different fee. While a theoretical vision might suggest that precise and timely market data can drive tailored and dynamic anti-dilution measures when warranted, operational logistics make such an approach less feasible. A stable framework that is periodically revisited and revalidated is likely more operationally viable.

In the absence of credible methodologies to identify and measure material dilution, we remain cautious regarding attempts to estimate and impose estimated costs of liquidity with greater and greater degrees of precision without a corresponding sense of the marginal benefits.

These trade-offs will likely lead to different applications and measures being used by different funds with different facts. It will also likely lead funds to conclude that reasonable estimates are sufficient without attempting to add variability and dynamic elements to their programs. IOSCO guidance should acknowledge that as an acceptable outcome.

13. **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?**

If the premise is that investors need to know that transaction costs may be allocated to their redemption or subscription orders, disclosure that a fund has such a feature is sufficient. Funds can clearly disclose the presence and use of LMTs.

Specific details about the mechanism, calculations, trigger thresholds, ranges of cost adjustments, etc. are subject to board or other governance body oversight, but LMTs should be treated similar to other operational aspects of fund operations in terms of whether they are sufficiently material to warrant detailed disclosure.

We believe that funds should not be required to publicly disclose transaction costs or swing factors. Disclosure could provide an avenue for savvy investors to attempt to "game the system" by strategically timing their purchases and redemptions based on expected swings. Although a few European funds selectively disclose their swing factors and swing pricing thresholds, many have chosen not to publicly disclose this information and only disclose the maximum factors for these same reasons.

We also note the statement in page 18 of the Consultation: "Conservatively calibrated subscription / redemption fees could be effective in mitigating potential dilution impact in OEFs. Such practice may also be useful in jurisdictions where there are operational hurdles to obtaining timely fund flow information for assessing dilution impact to be incorporated in anti-dilution LMTs."[9] Any guidance should recognize that "conservative" calibrations could result in charging unwarranted and excessive costs to redeeming or subscribing shareholders.

It is crucial that any LMT be solely focused on fair allocation of dilutive transaction costs. Any additional costs unfairly penalize redeeming or subscribing shareholders and unfairly benefit fund shareholders. Given the uncertainty and lack of consensus on methodologies to identify and measure material dilution, LMTs must not intentionally or unintentionally become a transaction penalty.

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[9] This statement also rightly acknowledges the variety of operational hurdles that exist in different jurisdictions, further emphasizing the drawbacks of any "one size fits all" framework.

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

While there may be no regulatory mandate for disclosure of details or ranges of liquidity costs, there also ought to be no prohibition for funds that wish to make such disclosures. We agree with the Consultation's use of the term "may" rather than "must."

However, we believe that an unlimited maximum could erode investor confidence. If an investor believes they could be subject to an unlimited cost that could attach at any unknown point in the future, they may be reluctant to assume that risk. It would be reasonable for a fund to set a maximum fee or charge with the knowledge that, in theory, there could be a circumstance where calculations could press to and beyond the maximum. This is balance that a fund should be able to set.

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

The Consultation states: "Under normal market conditions, the cost of liquidity could usually be estimated with a high level of confidence. Under stressed market conditions, transaction costs may become more unpredictable and econometric models may not be fit for purpose. In such cases, it would be appropriate for responsible entities to rely on expert judgement to account for uncertainty based on available information."

In the absence of commonly agreed methodologies to identify and measure material dilution, we remain skeptical that the cost of liquidity can be estimated with a "high level of confidence" in normal markets and stressed markets. Reasonable estimates can be made within the limits of available data and methodologies and all market participants should understand the limitations of those calculations. We also recall that the starting point for estimates in the guidance was assuming a pro-rata slice which may not actually reflect how a fund is managing its assets and liquidity. This means that levels of confidence in calculations are inherently limited from the outset. Accordingly, we believe that guidance should carefully consider the marginal benefits of pushing for greater and greater degrees of precision.

We also believe that guidance should consider how dynamic ongoing liquidity assessments can be in practice. While the theory might suggest a framework that adapts to market conditions will better estimate actual transaction costs from that specific market, there are substantial challenges involved inbuilding an operations infrastructure that is stable, repeatable, and explainable. For example, applying "expert judgment" in unusual market conditions may prove difficult to incorporate in practice. During such conditions, the experts are likely fully engaged in making investment decisions and making credible subjective assessments on the fly could be difficult to document and build into repeatable processes.

The proposed guidance suggests that the "degree of sophistication of the estimation is expected to be commensurate with the fund's overall portfolio profile, such as fund size, complexity of strategies, types of asset classes and their market liquidity, investment sectors, redemption terms and conditions of the OEF, as well as the overall liquidity risk management framework."[10]

We agree that different approaches may be appropriate for different funds with different facts. Taking relevant factors into consideration will help avoid results that allocate excess costs to both those transacting or holding fund shares. We strongly urge guidance to think of sophistication as a principles-based approach where funds can exercise their judgment to design approaches that work best for them. We believe that prescriptive approaches that create a checklist of factors that must be addressed and determine how they are addressed will not be as effective.

A sufficient solution may not always be the most complex or sophisticated. Funds could consider a wider variety of factors if they have more complex facts, but an LMT tool does not need to be complex to be effective. In fact, adding complexity may add costs and operational challenges rather than providing marginal benefits. Regulatory expectations should be properly calibrated to the potential benefits. We encourage IOSCO guidance to recognize that simpler tools may be reasonably sufficient for the need and defer to funds to make those judgments.

Regulatory mandates must balance the need to be flexible enough to adapt to different funds while being consistent enough to avoid establishing different regulatory obligations for different market participants depending on their size. Guidance should be principles based and then administered and enforced prudently. While an individual fund may be capable of building an extremely sophisticated multi-factor programs infused with data and modeling, such a complex and costly program may not always add marginal benefit and should not be the minimum standard required as a matter of law.

Proposed Guidance 4 – Appropriate Activation Threshold

16. **What are the appropriate factors to consider in setting the activation threshold so that antidilution 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?**

We agree with the consultation's assertion that "LMTs are not necessarily expected to be activated at all times."[11] If the starting premise is allocating transaction costs, there are risks to LMTs that are both too high or too low.

LMT use should be reserved for unusual circumstances rather than ordinary course markets. Funds are highly incentivized to minimize transaction costs, whether they are making investment decisions with existing assets or managing for incoming our outgoing cash flows. Those incentives remain in all market conditions.

[10] IOSCO Consultation Report, July 2023 at Page 19.
[11] ISOCO Consultation Report, July 2023 at Page 20.

Activation thresholds should be set high enough that they are activated when the fund believes that transaction costs present a high risk of significant erosion to shareholder returns. That threshold may be different for funds based on their asset class, liquidity profile and shareholder behavior.

The Consultation suggests LMTs could be activated based on a pre-determined net flow trigger or a trigger based on estimated liquidity costs. We continue to believe that such design decisions ought to be up to each fund and that no credible alternative should be prohibited and no specific measures should be mandated.

Timely and reliable net flow information may not be available. In the United States, most fund shareholders invest through intermediaries and retirement platforms and orders through those channels may not be known to the fund at the time it strikes its NAV.[12] In that case, setting a net flow trigger may not be a viable option which influences the LMT tools available. Market and infrastructure variations such as these across the globe support principles rather than prescriptive approaches.

17. **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?**

Trigger or cliff-edge effects may occur if the triggers are published or otherwise known. We believe that funds should be permitted to design and administer individual LMT programs without being required to publish key parameters. A fund should be permitted but not required to disclose such information.

Likewise, there may be implications to unknown triggers or thresholds. If investors do not know whether an LMT will be activated, the LMT may either have no effect or push investors to move quickly to avoid a possible LMT-related charge.

For example, an LMT could be triggered by a net flow threshold. Investors placing orders don't know the behavior of other investors, so no single investor knows whether the net flow threshold will be met and LMT triggered. If the investor does not know whether they will bear an LMT cost or not, one possibility is that LMT will not be a driver of their decision-making and therefore has no impact on the "first mover" advantage. The "first movers" will still move first.

Another possibility is that the uncertainty may drive more redemptions in a time of market stress as investors fear that the pace and volume of redemptions might be growing, so they want to redeem before redemptions reach a trigger threshold. Such behavior could be a self-fulfilling prophecy and create early movers that did not exist previously. This is type of behavior occurred in U.S. non-government money market funds in March 2020 when anticipated imposition of fees and gates in prime funds caused redemptions rather than actual fees and gates.

[12] These constraints are recognized in the IOSCO Consultation Report, July 2023 at Pages 28 and 29: third bullet in the "Market-wide Structural and Operational Barriers" section.

<u>Proposed Guidance 5 – Governance</u>

18. Do the proposed arrangements discussed above include all the essential elements regarding governance and oversight arrangements in relation to the use of anti-dilution LMTs? Are they proportionate to the differing size and complexity of responsible entities' fund ranges?

Each fund should be able to design their own liquidity risk programs and how those programs are structured and operated. We believe that any regulatory guidance should not attempt to define or mandate prescriptive elements of fund operations. We also believe that the magnitude of resources and cost required to design, implement, and administer LMTs should be proportionate to the potential benefits. A single fund with low risk for material dilution risk should not need the same infrastructure and governance of a fund complex with much higher risks.

The breadth of business models and organizational structures makes it challenging to design, implement and administer common programs. In some cases, funds may already have structures where it makes sense to incorporate consideration of dilution risk rather than create stand-alone groups or committees. In other cases, funds retain one or more sub-advisers so there is a distinct separation between those who are responsible for fund valuation, distribution, and administration and those who make investment decisions. Sub-advisory structures often span the globe with a fund domiciled in one continent and investment decision making located multiple time zones ahead or behind. Guidance should not presume a particular business model or organizational structure.

In addition, funds may not have the internal expertise or tools to maintain a comprehensive LMT framework. Funds may find it necessary or prudent to engage third parties, particularly with the amount of data analysis and calculations that could potentially be involved. Regulatory guidance should be neutral on the use of third parties, but should recognize that involvement of third parties is a possibility which further illustrates that deference should be given to funds to organize and structure its own effort.

The guidance also contemplates ex-post reviews and back-testing. We agree that any fund operating a program should conduct sufficient assessments to reasonably determine whether the program is meeting its objectives, operating as expected, and complying with applicable law. However, back-testing should be viewed through a reasonableness lens given the limitations of data and estimates involved in LMT administration. We agree with the consultation's statement that programs should operate on a "best efforts" basis.[13] Opportunities for improvement and good faith judgements that turned out to be incorrect should be viewed as potential enhancements rather than regulatory violations. We also continue to caution that markets are dynamic, the future is unknown, data is limited, and LMT processes involve estimates. Ongoing reviews and back-testing may not always lead to calculations made with higher precision and confidence.

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

See prior response.

[13] IOSCO Consultation Report, July 2023 at Page 18.

Proposed Guidance 6 – Disclosure to Investors

20. **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?**

We agree with the Consultation's statement that "Investors should be given enough information prior to investing in the OEF to enable them to have a good understanding of the implications of anti-dilution LMTs."[14] As a general matter, shareholders are entitled to clear disclosure regarding the material elements of funds in which they invest.

As stated above, if the premise is that investors need to know that transaction costs may be allocated to their redemption or subscription orders, disclosure that a fund has such a feature is sufficient. Funds can clearly disclose the presence and use of LMTs.

Specific details about the mechanism, calculations, trigger thresholds, ranges of cost adjustments, etc. are subject to board or other governing body oversight, but LMTs should be treated similar to other operational aspects of fund operations in terms of whether they are sufficiently material to warrant detailed disclosure.

Funds should not be required to publicly disclose threshold triggers or swing factors. Disclosure could provide an avenue for savvy investors to attempt to "game the system" by strategically timing their purchases and redemptions based on expected swings. Although a few European funds selectively disclose their swing factors and swing pricing thresholds, many have chosen not to publicly disclose this information and only disclose the maximum factors for these same reasons.

Shareholders should have a sense of the realistic maximum that they might be charged and a sense of whether such charges are applied in the ordinary course or limited to unusual circumstances. We believe that can be accomplished without providing a granular description of methodology, calculation inputs, etc.

Shareholder disclosure should be sufficiently evergreen such that a fund can change logistics and details of the LMTs without waiting to update prospectus disclosure for all shareholders or send update notices to all shareholders. LMT mechanics should be viewed like valuation methodologies – the relevant fund actors and committees are charged with maintaining the program and making changes but not every aspect of the program or change requires disclosure. This principle suggests that general disclosure about the presence of an LMT is preferred over more specific disclosure about the operation of an LMT.

Disclosure may be warranted for larger changes that directly impact operational logistics such as moving from swing pricing to liquidity fees or bid-ask pricing. Transparency would be prudent because shareholders would see differences in their trade order confirmations and need disclosure to understand the economics of their trade. In part, this is for the benefit of shareholders, but implementation logistics may also require notice to other impacted parties (such as intermediaries

[14] IOSCO Consultation Report, July 2023 at Page 26.

and recordkeepers). More disclosure and more preparation time required for implementation means that funds will not be able to quickly change LMTs being utilized.

21. **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 antidilution LMTs or creating unintended consequences? Further, how soon should this information be disclosed to investors?**

Ex-post reporting should be permitted but not mandated. If there is shareholder interest, funds could elect to disclose information about the magnitude and frequency of LMT adjustments and activations. Not all shareholders may be interested in the data or would take the data into account when they make investment decisions. Fund policy and practice is a balance that each individual fund should be able to set.

While we generally endorse principles of shareholder transparency, individual shareholder interest in the granular details of estimates and calculations may impose operational cost and friction on the fund that other shareholders or the fund's sponsor and advisers would bear. It might also require disclosure of methodologies and mechanics that could give an individual shareholder an advantage over others. Guidance should recognize the role of the fund board or other oversight body and auditors rather than shareholders in terms of oversight of the mechanics of LMT tools.

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

All LMT solutions have trade-offs. The more complex, the more difficult to maintain and explain. If the tools are complex, they make disclosure and shareholder transparency more complex.

No credible solution should be prohibited and no specific solution should be mandated. There is no one-size-fits-all solution and each fund should have the latitude to select and design their own LMT programs where there is a risk of material dilution. These themes are consistent with the proposed IOSCO guidance.

With those principles, there are real risks to shareholder confusion, unnecessary and immaterial disclosure, and disclosure that can permit some investors to gain an advantage over others. Accordingly, individual funds that believe they have a material risk of dilution are best positioned to determine what disclosure is prudent to describe their LMT approach while balancing the risks and needs to maintain the program for the benefit of the shareholders the LMT is intended to help.

<u>Section V - Overcoming Barriers and Disincentives to Implementation of Anti-Dilution Liquidity Management Tools</u>

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

We agree with the Consultation's statement that investors may fear that they are penalized more than warranted by the imposition of existing liquidation costs.[15] Our comments above highlighted the difficulty of identifying and estimating material dilution, the implications of stipulating a pro-rata slice methodology, and the difficulties of obtaining precise data (particularly in times of market stress). We also cautioned that a "conservative" approach could unfairly penalize transacting shareholders by allocating estimated costs that are greater than actual. Any credible LMT must be tied to allocating transaction costs and guard against becoming a trading penalty. For these reasons, we believe that LMTs should be narrow in scope, used sparingly, and described transparently and accurately. If investors are misled regarding precision, objectives, use, and impact, they will view LMTs as nothing more than added costs.

Operational implications exist and vary by jurisdiction, which add complexity and limit the viability of certain LMT tools. Some operational hurdles may be easier to reduce than others. We encourage IOSCO and member regulatory bodies to continually measure the potential benefits with the costs involved in changing operational hurdles to accomplish broader use of LMTs. If actual material dilution is limited, then the corresponding costs to address should be kept in proportion.

The Consultation identifies lack of bid-ask data and fund flow data as potential barriers.[16] We agree and note that neither challenge might be easily solved. Fund flow data is a function of the broader fund network of shareholders, distributors, intermediaries, recordkeepers and others. Mandating timely and accurate flow data could require major changes to how relevant parties interact and invest in mutual funds. It is good example of keeping the corresponding costs to change in proportion with the potential benefits.

Bid-ask data is another challenging subject. There is more information and data available today than ever before. However, data is not free, and reliable data – particularly in fixed income markets - does not always exist for abstract points of interest such as market impact and pre-trade price transparency. This situation is exacerbated in times of market stress when arguably most important for the operation of LMT tools.

No set of guidance can force data to exist. Instead, we urge guidance to recognize the limitations of data, avoid relying on data that may not exist or be credible, and keep the broader context in mind of "reasonable" and "best efforts." LMT ought to be directionally correct without expecting them to be precisely refined. This is especially the case in the absence of agreed methodologies to identify and measure material dilution and the use of models and estimates involved. Funds can incorporate and utilize data as it is available, but any LMT guidance should accept the data landscape as it is rather than what we might wish it to be.

[15] IOSCO Consultation Report, July 2023 at Page 28.
[16] IOSCO Consultation Report, July 2023 at Page 29.

24. **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?**

Two significant factors warrant highlighting.

First, the IOSCO guidance primarily focuses on the investor protection rationale for LMT measures.

Questions remain, however, about the rationale that LMTs solve a "first mover" advantage. The "first mover" advantage suggests that in times of market stress, investors move quickly and cause excess redemptions and corresponding transaction costs that all shareholders bear. These investors could be very savvy and agile, driven by the desire to avoid transaction costs as opposed to moving out of a fund, strategy and/or asset class for investment reasons. Conversely, investors operating out of panic cause excess redemptions out of fear rather than rational investment decisions to preserve capital in times of stress. In both cases, the rationale is that a shareholder who bears a proportionate share of transaction costs no longer has the incentive to move quickly out of a fund.

Further work is required to validate this theory in practice and confirm that transaction cost avoidance actually drives investor behavior. Do investors make decisions in times of stress based on avoiding transaction costs? In jurisdictions using LMTs, do shareholders fully understand LMTs? If so, does the presence of LMTs influence how they make investment decisions in times of stress?

In times of stress, flights to quality to preserve capital are a major part of investor behavior and could overwhelm concern about avoiding transaction costs.

If more widespread use and acceptance of LMT tools is based on solving a "first mover" advantage, more data-driven validation work should be conducted to give that rationale additional credibility. Otherwise, it will not resonate with shareholders who think in terms of saving 500bps of capital rather than 50bps or less of transaction costs.

Further work should also be done on methodologies to identify and calculate material dilution risk. At present, the lack of consensus on agreed approaches is a barrier to implementation. It is insufficient to base regulatory mandates purely on estimates and guesswork about what might or might not be happening in the market.

Second, we re-emphasize the potential for challenges presented to distributors, intermediaries and recordkeepers. Operationalizing LMTs involves them and their workflows, technology, and infrastructure as well. The task becomes more complex as different funds elect different LMT tools with unique features. Funds do not operate in a vacuum, so the guidance or regulatory mandates need to be flexible enough to allow for consideration of such factors.

25. **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?**

The Consultation's questions rightly note the operational, regulatory and logistics challenges that various funds might confront in their respective markets. The Consultation's questions also illustrate challenges that arise with broader use and more complex LMT tools.

Anti-dilution should be thought of as an incremental process rather than a single solution. We believe that LMT tools should apply to only funds with material dilution or a risk of material dilution. We also believe that estimates are an inherent part of measuring material dilution and calculating corresponding costs to allocate. There are a number of operational challenges that heavily influence what LMTs are feasible. With that backdrop, we suggest that guidance should focus on parts of the market with higher risk and lower operational challenges.

Other questions

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

Liquidity does not exist in a vacuum and should not be taken for granted. Open-end funds around the world operate as part of the broader capital markets. Accordingly, we encourage the FSB to consider the impacts of bank regulation on liquidity, such as Basel III endgame concepts currently under consideration in the U.S.

We are concerned that the U.S. Basel III "Endgame" will overhaul the current risk-based capital framework and dramatically increase capital requirements for the largest U.S. and internationally headquartered banks' trading activities. We struggle to see adequate justification for such an increase in capital requirements for the trading book, particularly given how resilient U.S. markets have been since the Global Financial Crisis. We are also concerned about adverse impacts that bank regulation might have on the ability for banks to offer affordable lines of credit which can be useful tools for investment funds to manage liquidity.

The U.S. funds 75% of commercial activity through its capital markets. Imposing dramatic increases in capital on the trading book will likely result in increased costs and/or reduced capital and credit to end users.

While considering liquidity risk management practices at open-end funds is appropriate, we strongly believe that liquidity is a much broader issue and the sources and drivers of market liquidity need to be part of the discussion. Reducing the ability of market participants to remain actively involved in the capital markets frustrates rather than facilitates liquidity.

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We look forward to continuing to participate in future discussions regarding liquidity risk for open-end funds. We stand ready should you have any questions about our response or the subject more broadly. Please contact Kevin Ehrlich at 202.962.7336 or kehrlich@sifma.org or Thomas Price at 212.313.1260 or tprice@sifma.org if you have questions.

Respectfully submitted,

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