DeNederlandscheBank
EUROSYSTEEM

AFM

Date	4 September 2023
Our reference	MkPs-23022617
Page	1 of 10
Subject	Sector letter availability liquidity management tools

Dear Members of the Board,

1. Introduction

The Dutch Authority for the Financial Markets (**AFM**) and De Nederlandsche Bank (**DNB**) supervise compliance with the rules for (liquidity) risk management that apply to managers of investment funds and UCITS. It is important to keep an overview of material issues that affect funds and to have insight into the extent to which funds and investors run risks. Therefore, in 2022, the AFM performed a survey among managers of investment funds domiciled in the Netherlands on the availability and use of liquidity management tools (**survey**). The purpose of the survey was twofold. First, the AFM wanted to take stock of the liquidity management tools (**LMTs**), listed in Table 1 in the Annex, available for funds managed by fund managers domiciled in the Netherlands. Second, the AFM wanted to verify whether the information disclosed reconciles with the information reported under the AIFMD obligation.

The objective of this letter is to (i) provide fund managers feedback on the results of the survey, (ii) provide guidance regarding the availability of LMTs and (iii) to clarify the notification procedure to the AFM on the activation of LMTs.

Results of the survey show that most funds have three or more LMTs at their disposal, which may assist them when facing market stress.

However, there are some findings from the survey that require attention from fund managers:

1. Certain funds only have a limited number of LMTs at their disposal and in some cases do not have the possibility to suspend redemptions.
2. The AFM observed discrepancies between the survey response and AIFMD reporting.
3. Some responses in the survey appear the result of an erroneous interpretation of the term activated LMT.
4. The notification period for some funds – especially for illiquid funds – appears to be short.

The AFM and DNB have been stressing the need for fund managers to have sufficient and appropriate LMTs at their disposal, irrespective of the type of investor (e.g., retail or institutional). AFM research for ESMA (2020) showed that not all investment funds had sufficient LMTs available. The AFM subsequently stressed fund managers to consider whether the LMTs at their disposal were sufficient and appropriately tailored to the fund's characteristics.[1]

The AFM and DNB reiterates their earlier recommendations. More specifically, the results of the survey require the following actions:

1. The AFM and DNB calls upon fund managers to regularly review their liquidity management practices and, where necessary, make appropriate LMTs available by amending the prospectus.
2. If amendments to the prospectus are introduced, amendments must be notified to the AFM and to the investors. This letter includes guidance on how fund managers should inform the AFM on the availability and use of LMTs.
3. The AFM expects that fund managers of AIFs report the activated LMTs in the AIFMD reporting. Based on the discrepancies found between the survey results and the AIFMD reporting, the AFM expects fund manager to compare their response to the survey with the responses to the AIMFD reporting and correct any discrepancies in the AIFMD reporting.

This letter further describes:

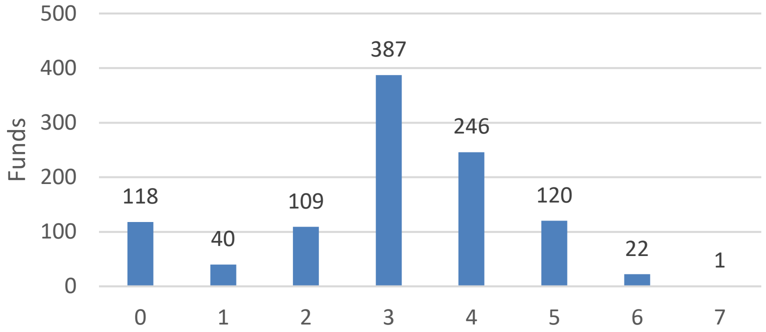
2. General overview of the survey results
3. Findings from the analysis of LMTs
4. Procedures to inform the AFM on the availability and use of LMTs
5. Conclusion

2. General overview of the survey results

Most investment funds have one or more LMTs at their disposal. Out of 1043 investment funds only 118 funds have no LMT available (Figure 1). These funds are almost exclusively 'closed end' funds. These funds do not directly face liquidity risk stemming from fund outflows and hence have no immediate need for LMTs. However, should these funds have a specified termination date, fund managers should consider appropriate procedures to ensure an orderly unwind of the fund. Generally, most investment funds have three or more LMTs at their disposal. All investments funds with LMTs (925 out of 1043) have a total of 3.142 LMTs available.

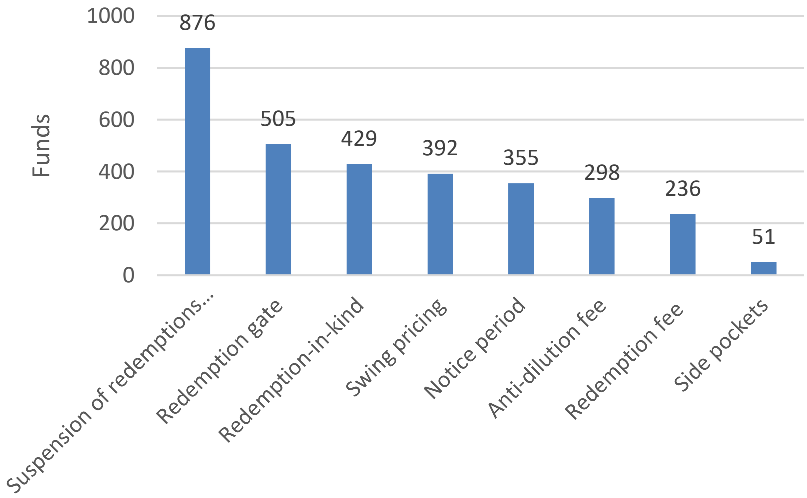
[1] ESMA (2020) "esma34-39-1119-report_on_the_esrb_recommendation_on_liquidity_risks_in_funds.pdf (europa.eu)", and the subsequent https://www.afm.nl/~/profmedia/files/doelgroepen/beleggingsinstellingen/2021/bi-publicatie-covid-19-overzicht.pdf?la=nl-nl.

Figure 1: Funds and number of available LMTs included in their prospectus



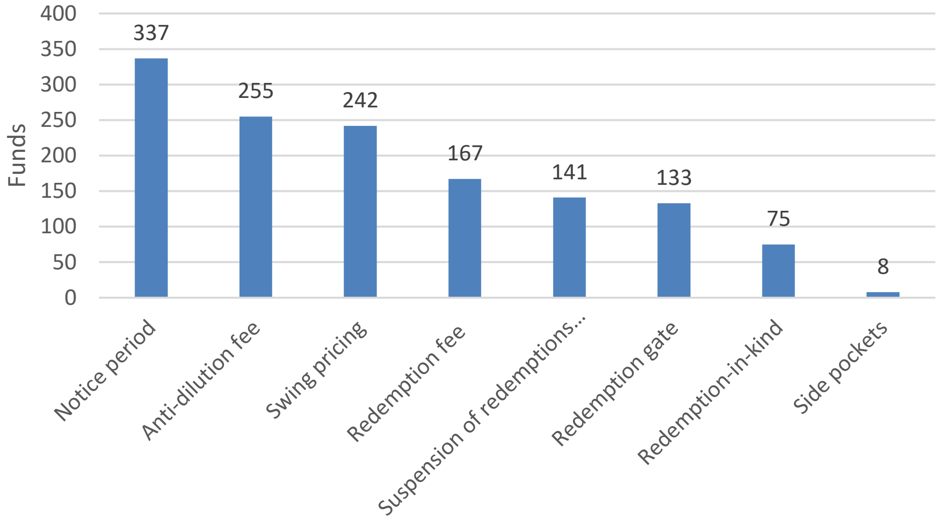
Suspension of redemptions and subscriptions is the LMT most commonly available, whereas side pockets are not frequently available (Figure 2). Almost all funds with one or more LMTs have suspension of redemptions and subscriptions at their disposal (876 out of 925). Redemptions gates, redemption in kind, swing pricing, notice period, anti-dilution fee and redemption fee are also commonly used as LMT. Finally, only 51 funds included side pockets in their prospectus as an LMT.

Figure 2: Types of LMT available



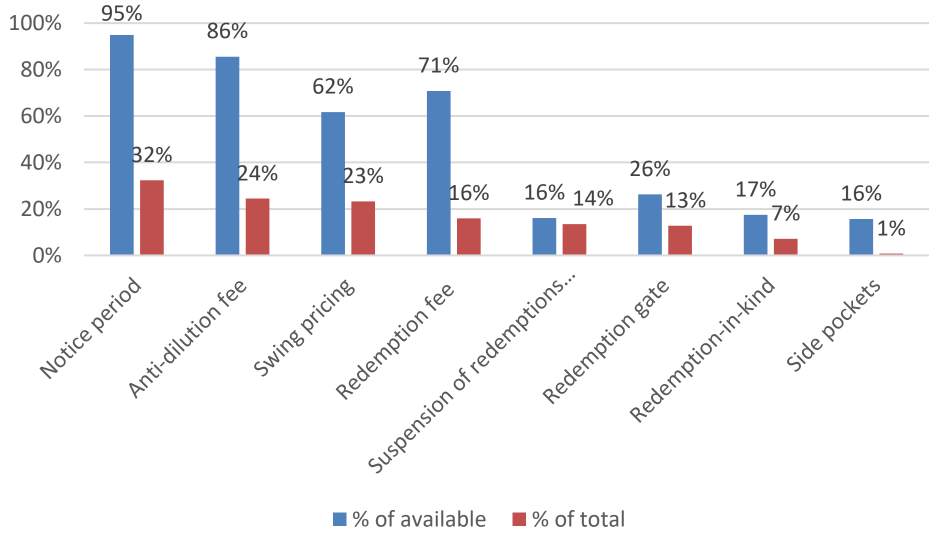
Most funds have activated one or more LMTs. According to the survey, around 75% of all investment funds (730 out of 1042) activated one or more LMTs (Figure 3). Combined, some 1.350 LMTs are active, with a number of individual funds using multiple LMTs. This implies that, according to the survey, close to half of all the available LMTs are activated.

Figure 3: Activated LMTs



The most frequently activated LMT is a notice period, while LMTs with pricing characteristics (e.g. anti dilution fee, swing pricing and redemption fee) are also relatively common. These findings hold both in absolute and in relative terms.

Figure 4: Relative activation of LMTs



3. Findings from the analysis of LMTs

The AFM found some discrepancies between the information provided in the survey and information that the AFM received in the AIFMD reporting. Furthermore, it appears that the questions in the survey were not always consistently interpreted by fund managers. This appears to be particularly the case in interpreting the definition of ''available LMTs'' and ''activated LMTs''. The most important findings requiring follow up by fund managers are detailed below. The AFM and DNB emphasize that the findings selected below are the ones deemed most important and should not be considered an exhaustive list of findings.

a. Minimum suggested number of LMTs and discrepancies between survey responses and AIFMD reporting
b. Available LMTs versus activated LMTs
c. Potential liquidity risks

a. Minimum suggested number of LMTs and discrepancies between survey responses and AIFMD reporting

Certain open-end funds have no LMTs at their disposal. Furthermore, not all funds have the LMT 'suspension of redemptions' available. The AFM and DNB would suggest that suspensions of redemption should always be available. Without the possibility to suspend redemptions, a fund manager is expected to always fulfil the redemption request within the timeframe communicated in the prospectus, also in stressed market situations. The AFM and DNB have stressed before that fund managers should have sufficient and appropriate LMTs available. The AFM and DNB emphasize that the LMT 'suspensions of redemptions' is a useful tool to have at the disposal of a fund manager. Fund managers who reported that they do not have suspensions of redemptions available should therefore review their liquidity management procedures and, if appropriate correct this through an amendment of the prospectus. The AFM notes that a change in the prospectus must be notified to the AFM.

The AFM also found that information provided in the survey and information reported in the AIFMD reporting do not always reconcile. For instance, some open-end funds who reported to have activated redemption gates do not report a gate in the AIFMD reporting. If a redemption gate is activated, the AFM expects that in the AIFMD reporting the rate of a redemption gate is reported as larger than zero. Furthermore, the AFM found that some open-end funds do not report their redemption frequency in the regular AIFMD reporting. The AFM expects this to be rectified at the next reporting opportunity.

b. Available LMTs versus activated LMTs

According to the survey responses, 43 percent of the available LMTs are also activated. This does not match with the information the AFM received from earlier notifications from fund managers. The activated LMTs are not limited to notification periods or anti-dilution tools, but also include redemptions-in-kind, side-pockets and suspensions. Specifically, at the time of the survey, 128 funds have answered that suspensions of redemptions were active, seven funds indicated that side pockets were active, and 74 funds had redemptions-in-kind active. Based on notifications received, the AFM was only notified of one fund being suspended and of two funds having activated side pockets.

A number of participants may have considered that availability of LMTs by default imply these are then also ‘activated’, rather than actually applied. Furthermore, some fund managers may be unfamiliar with the obligation to notify the AFM once a LMT is activated. Regarding the latter, the AFM would like to stress that if any of the LMTs mentioned in Table 1 is activated, it is obligatory to notify the AFM in accordance with the procedure to notify the AFM as set out in the next section of this letter.

The AFM would like to point out the difference between available LMTs and activated LMTs.

- **Available LMTs**: This refers to LMTs that are available to the fund manager to potentially use in their daily management of liquidity. Available LMTs need to be communicated to the public via the prospectus. However, LMTs that are not formally activated, are not part of the prevailing redemption policy framework.

- **Activated LMTs**: This refers to LMTs that are available to the fund manager and are an effective part of the daily liquidity management of the fund, meaning that every investor is subject to the activated tool. A tool can only be activated if this tool is available according to the prospectus. It is possible that some tools are always active, such as anti-dilution tools as fees, swing pricing or a notification period. If a tool is always active and thus part of the normal redemption and subscription procedure, then this must be mentioned in the prospectus. Activation of an available LMT must be communicated to the investors immediately after activation.

Box 1 – Examples of available versus active LMTs

If funds have the possibility to suspend redemptions then this availability must be mentioned in the prospectus. If it is reported in the survey that suspension of redemption has been activated, as 128 funds have done, this in practice means that investors cannot redeem or subscribe to the fund. The fund is effectively closed. A fund that suspends its redemption and subscription must also immediately notify the AFM and its investors.

If a fund that has the possibility to restrict the outflow from the fund to a certain percentage but does not apply this in its regular redemption procedure to every investor, then redemption gates are ***available*** to the manager but not ***activated***. The availability of gates should be mentioned in the prospectus. Activated redemption gates mean that for every investor that wants to redeem the outflow is limited to the percentage stipulated in the prospectus.

Anti-dilution tools, such as redemption fees, anti-dilution levies or swing pricing, are tools that are generally applied in regular redemption procedures. These tools are then characterized as being always activated. These tools must be mentioned in the prospectus and are applied on a daily basis to every investor who wants to redeem or subscribe to the fund.

All LMTs that a fund manager seeks to have available in its liquidity management needs to be mentioned in the prospectus. The AFM calls upon fund managers to regularly review their liquidity management practices and if needed make LMTs available by amending the prospectus. These amendments must be notified to the AFM and to the investors.

c. *Potential liquidity risks*

In general, funds need to make sure that the redemption profile is in line with the liquidity of the underlying assets, mitigating liquidity mismatches. The AFM and DNB are of the opinion that redemption frequencies and notification periods should match with the liquidity profile of the underlying assets. The AFM and DNB observed that a number of funds that invest in less liquid assets, such as corporate bonds and real estate, have a notification period that is shorter than the liquidation period of fund assets. Consequently a liquidity mismatch may occur if underlying assets cannot be liquidated in a timely manner to meet redemption requests. Also if accounting for notice periods. This especially may be the case with real estate as the underlying asset. A low redemption frequency, for instance yearly, does not protect against a sudden liquidity demand if the notification period is very short, e.g. a business day, or a month.

In line with some of the concerns and warnings of international organizations and standard setters, the AFM and DNB share the opinion that to address liquidity risks, funds need to have sufficient LMTs available and in the case of less liquid assets, a notification period is needed. In a recent published warning on commercial real estate (CRE)[2], the European Systemic Risk Board (ESRB) recommends that supervisory authorities promote resilience of investment funds by making sure that appropriate LMTs are used and that there is structural alignment between fund redemption terms and liquidity of underlying assets. The latter also follows directly from Article 16 of the AIFMD and implemented in Article 3:17 of the Wft and Article 26.1 of the Bpr.[3]

4. Procedures to inform the AFM on the availability and use of LMTs

The AFM emphasizes that managers of AIFs and UCITS must immediately inform the AFM and investors if the determination of the net asset value (NAV) is suspended or if another LMT mentioned in Table 1 is activated. The AFM is of the view that the activation of an LMT is a material change in fund terms. Furthermore, a LMT can only be activated if the LMT is mentioned in the prospectus. The AFM calls upon managers to notify the AFM of any LMT that is activated.[4]

The AFM would like to emphasize that changes to the available and activated LMTs must be reported to the AFM in accordance with the usual procedure, via the email address: meldingenaifmd@afm.nl or toezicht_am@afm.nl. For consistency in reporting, we request that you use the Excel template enclosed with the survey and this letter when reporting any change in the available and activated LMTs.

The AFM also emphasizes that AIFs should report activated LMTs in their AIFMD report. This refers to reporting items 197 through 201 of the reporting template. As long as an LMT is active, the AFM expects AIFMs to report this LMT in its periodic reporting. This also applies to LMTs mentioned in Table 1 and that are always activated as part of the normal redemption policy.

5. Conclusion

Investment funds play an important role for the real economy. They can however – especially in times of stress – face liquidity risks. This is not only problematic from an investor protection point of view, but also from a financial stability perspective. Therefore, the AFM and DNB emphasize the importance for funds to have appropriate LMTs.

Results of the survey show that most funds have three or more LMTs at their disposal, which may assist them if and when facing market stress. However, there are some findings from the survey results that

[2] ESRB (2022) "Recommendation of the European Systemic Risk Board on vulnerabilities in the commercial real estate sector in the European Economic Area (ESRB/2022/9)".

[3] Art. 16 AIFMD, Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010Text with EEA relevance (europa.eu).

[4] Article 4:26 of the Dutch Financial Supervision Act (*Wet op het financieel toezicht* – Wft) and Article 88-92a of the Decree on Conduct of Business Supervision of Financial Undertakings (*Besluit Gedragstoezicht financiële ondernemingen* – Bgfo).

require attention from fund managers. First, certain funds have a limited number of LMTs at their disposal and in some cases do not have the possibility to suspend redemptions. Second, the AFM found discrepancies between the survey and AIFMD reporting. Third, some responses in the survey appear the result of an erroneous interpretation of the term activated LMT. Fourth, notification periods for certain funds – especially for less liquid funds – is rather short.

This letter contains guidance on how fund managers should inform the AFM on the availability and use of LMTs. The AFM and DNB expect funds to follow-up on the findings presented in this letter as soon as possible.

Yours sincerely,

A.B.F. Hilgevoord
Head of Department
De Nederlandsche Bank
Investment Firms and Collective Investment Schemes

P.J. van der Linden
Manager
Dutch Authority for the Financial Markets
Asset Management

Annex

Table 1: Overview and description of liquidity management tools

Notice period	A notice period refers to the period of advance notice that investors must give to fund managers when redeeming their shares.
Anti-dilution levy	An anti-dilution levy is a charge applied to individual transacting investors, payable to the fund, to protect remaining investors from bearing the costs associated with purchases or sales of assets because of large inflows or outflows. An anti-dilution levy does not involve any adjustment to the value of the fund's shares.
Swing pricing	Swing pricing can be used to adjust the price of shares in an investment fund so that it reflects the cost of fund transactions resulting from investor activity.
Redemption fee	A redemption fee is a fee charged to investors when redeeming their fund's shares.
Suspension of redemptions and subscriptions	Suspension of redemptions and subscriptions implies that investors are temporarily unable to redeem or purchase fund's shares.
Redemption gate	A redemption gate is a temporary restriction of the right of shareholders to redeem their shares. This restriction may be full, so that investors cannot redeem their shares at all, or partial, so that investors can only redeem a certain portion of their shares.
Redemption-in-kind	Redemptions-in-kind allow the fund manager to meet a redemption request by transferring securities held by the fund, instead of cash, to the redeeming shareholders.
Side pocket	Side pockets allow illiquid investments to be separated from remaining liquid investments of the investment fund.