INVEST EUROPE

Response to IOSCO Consultation on its Revised Recommendations for Liquidity Risk Management for Collective Investment Schemes

Introduction

Invest Europe responds to this consultation as the association representing the European private equity, venture capital and infrastructure fund managers as well as their investors.

As IOSCO is aware, private equity funds, which are traditionally set up as closed-ended funds, are generally synonymous with illiquidity. Because of the long-term nature of the asset class investments, which requires invested businesses time to mature, investors cannot easily sell their shares or interests in the fund whenever they want. Unlike publicly traded stocks, which can be bought and sold on the open market, private equity investments are locked up for a specified period, on average five to six years.

For this reason, we are responding to this consultation on behalf of a subsection of the private equity market and concentrate our response on asking IOSCO to carefully draft its Recommendations to acknowledge very specific types of open-ended structures, known as "semi-liquid" funds.

We argue that IOSCO has a key role to play in recognising the nuances across the different structures. It also must ensure that these Recommendations do not, while maintaining a coherent and safe approach to liquidity fund management, disincentivise the set up of specific fund strategies. For this, it is important IOSCO's proposals remain sufficiently flexible to account for the realities of all market strategies, provided of course these strategies can demonstrate they provide the sufficient safeguards in terms of financial stability and investor protection.

Overall, we fully share IOSCO's view that **there is no 'one size fits-all' approach to liquidity risk management** and that responsible entities should exercise their sound professional judgement in the best interests of investors. We further agree that **there are inter-relationships between asset liquidity, dealing, notice and settlement arrangements, the available LMTs and disclosure arrangements** which should be considered when designing an open-ended fund.

What are semi-liquid PE funds

Semi-liquid private equity funds are a relatively new type of investment vehicle that bridges the gap between traditional, illiquid private equity funds and more liquid public market investments. Their purpose is to offer investors the potential for higher returns associated with private equity (and other alternative assets) while providing a degree of liquidity not typically available in traditional private equity funds.

Semi-liquid funds often have a (semi) open-ended structure, which allows investors to invest and withdraw their capital at specific intervals (e.g. monthly or quarterly), subject to pre-agreed caps on how much capital investors can withdraw at any given time. Such caps help the fund manager to match the fund's portfolio of liquid assets (which can be liquidated to fund redemptions) to the maximum amount of redemptions that are permitted in a given period. Other features of these funds include long notice and settlement periods for redemption requests and a generally more diverse investment strategy than regular private equity funds.

With their hybrid approach, semi-liquid structures offer access to alternative assets to a new range of clients with a different liquidity profile, with positive impact on the overall diversification of portfolios. From a European regulatory perspective, the repurposing of the

ELTIF Regulation has equally made it more interesting for a small proportion of private equity managers to develop more liquid products. It is our assumption that there is at least a likelihood that semi-liquid funds would be categorised as Category 2 OEFs (as set out in IOSCO's Recommendation 3. Our response should be read in that context.

Recommendation 3: Consistency of OEF asset liquidity and redemption terms

1. Are the identified common components of OEF's structure including notice periods, lock-up periods, settlement periods and redemption caps accurately described? Are there any relevant additional considerations when setting the notice periods, lock-up periods, settlement periods or redemption caps?

We would like to use the opportunity of this question to flag to IOSCO that the private equity community:

1) fully supports the principle that any OEFs which allocate a significant proportion of its assets under management to illiquid assets should consider low redemption frequency and/or implementing long notice or settlement periods

From a practical perspective, this is already how all funds we describe in our introduction have set themselves up. There is a wide recognition that redemption periods should fit with the nature of underlying assets, and ultimately with the types of investors involved (most semi-liquid funds are only offered through sophisticated investors).

2) disagrees with the principle that responsible entities should necessarily consider structuring these funds as closed-ended CIS.

While the closed-ended structure is indeed more appropriate for long-term structures investing in illiquid assets, we feel that IOSCO's approach should better take into consideration the benefits semi-liquid structures - which are effectively open-ended but with closed-ended features - could have on allowing investors to commit capital to long-term funds.

While we do not disagree with the general principles IOSCO set in these Recommendations, we believe proposed recommendations should better account for the specificities of certain types of products which are structured precisely to bridge the gap between the needs of investors – typically sophisticated and generally long-term in their approach – and the features of long-term funds. This is particularly important as long-term capital is crucially needed to finance the transition towards a more sustainable economy.

In that light, we think there would be merit for IOSCO to further examine how its Recommendations fit with the realities of these structures as well as the benefits they may offer in terms of investor choice, while posing limited risks from the investor protection and financial stability risk perspectives.

In particular, we would suggest the following changes to the proposed descriptions to acknowledge the features of semi-liquid funds:

Notice periods

Notice period refers to the length of advance notice that an investor must give to a fund manager of their intention to redeem their investment from the OEF. Responsible entities use it to better align the OEF redemption frequency and the liquidity of the OEF's assets. If the OEF is invested in illiquid assets, a long notice period should be considered. ***It should be defined by the manager of the fund on an ad-hoc basis.***

Lock-up periods

A lock-up period in OEFs refers to the duration during which investors are not allowed, or incentivised not to redeem their shares or units, once the OEF has started to invest its capital, for an initial period of time. It is often used by OEFs that invest in illiquid assets, such as private equity, real estate, or other illiquid securities to allow managers to fully invest the capital and maintain a more predictable and stable investor base. This would allow the fund manager to make long-term investment decisions and maintain the desired asset allocation without having to constantly adjust the portfolio to meet redemption requests.

Settlement periods

Settlement periods refer to the time between the trade date when a redemption request is made and the date when the transaction of fund units and money are completed and settled. The typical settlement period for OEFs that invest in liquid assets is around one to three days, depending on the jurisdiction. It should however be flagged that the typical settlement period for OEFs that invest in illiquid assets can be far longer (typically up to 60 days).

Redemption caps

Redemption caps refer to the pre-set limitations placed on the maximum amount of assets that can be redeemed from OEFs within a given time frame (e.g., a day, week, month or quarter). They are typically used in OEFs that hold illiquid assets, such as real estate, private equity, private credit and other long-term assets to help the fund manager maintain an appropriate balance between meeting investor liquidity demands and preserving the OEF's investment strategy and performance.

Recommendation 6: Considering and implementing a broad set of anti-dilution LMTs, quantity-based LMTs and other liquidity management measures

2. Are there any other key considerations related to the availability and use of anti-dilution LMTs, quantity-based LMTs and other liquidity management measures under normal and stressed market conditions?

We agree with the principle that the first-mover advantage should be dissuaded in the case of OEFs with regular subscriptions.

However, we would like to stress that in specific cases, in particular for very illiquid structures, certain LMTs may be less appropriate than others. What is a effective LMT for a semi-liquid product is not the same as for a more liquid products. Making a differentiation between different strategies and product types will be relevant from the perspective of the client, of the manager and of financial stability. This was specifically recognised by the European Parliament in AIFMD II Level 1 as critical to appreciate, given the diversity of AIF structuring available under local law across Member States, and the resulting diversity of investment strategy and underlying assets.

The overarching concern is that generally **Anti-dilution LMTs (ADTs) are not suitable for semi-liquid structures** because semi-liquid funds hold, mostly, illiquid investments and as such it is not possible to create a pre-determined mechanism to adjust value of units based on liquidity. As such ADTs, may not always be viable LMTs for certain types of fund structures – and we feel IOSCO's Recommendations could in some case embolden public authorities to take too narrow approaches to what should constitute a proper mix of tools for certain fund structures.

It is important to maintain flexibility and discretion for the fund manager to utilise liquidity management tools in the manner they consider as most suitable. It follows therefore that the

Recommendations should not be unduly prescriptive. We have described below the challenges with ADTs for semi-liquid strategies.

As noted by IOSCO, illiquid asset classes such as private equity rely often on “hard locks” – or redemption caps – but they may also use other types of tools.

Here is our specific experience about the use of anti-dilution and quantity-based LMTs by semi-liquid private equity structures:

Redemption fees

Many semi-liquid AIFs have a fixed temporary early redemption fee (e.g. a 2% fee for redemptions requested within the first year of investment), known as a "soft lock". This fee effectively acts as an effective disincentive to redeem than a lower permanent redemption fee, similar to the "lock up period" referred to in Recommendation 3. This is an effective tool used by semi-liquid OEFs.

It is not yet clear whether regulators consider such mechanisms to fall within the definition of an ADT. As such the strong recommendation in Recommendation 3 for:

1. Category 2 OEFs to implement ADTs as described in Recommendation 6, and
2. that all OEFs should implement a broad set of LMTs including ADTs,

is too restrictive for the market to operate well.

Financial stability and investor protection concerns are paramount, but appropriate flexibility to tailor LMTs to an OEF's investment strategy and assets, and appropriate market transparency through disclosure and partnership with applicable national competent authorities will help support investor protection while ensuring that rules do not assume that all funds are faced with the same risk and all investors behave in the same way.

Conversely, a “redemption fee” such as the one proposed in AIFMD in EU law, is an example of an ADT that will not be suited to semi-liquid, private market fund strategies. The reason is, as described above, it would be practically difficult for illiquid funds to come up with a pre-determined range of redemption fee corresponding to transaction-based costs, as it would be challenging to estimate the cost of liquidity in stressed market conditions for illiquid investments and as the range may vary widely depending on asset type.

In order to meet the needs of specific investors, particularly mass affluent individuals, and the asset class in which the OEF will invest, managers need flexibility to set a redemption fee appropriate for the market and should be in a position to determine whether and how such perpetual fee should be applied – e.g. whether on redemption orders exceeding a percentage of NAV, aggregate repurchase requests or individual repurchase requests, and whether applied as a perpetual fee or more appropriately applied during a period of time.

Application of a redemption fee would be challenging given the advance notice that should be given in a scenario in which the redemption fee would be applied, so that investors have the ability to determine whether to withdraw redemption requests. Further, a perpetual fixed redemption fee would need to be very low in order for this fee to not disincentivise distribution entirely. It would also have only limited market acceptance for certain types of investors or limited distribution channels. It is as such not generally successful in the market in terms of offsetting redemption costs for non-redeeming investors or protecting the liquidity of a fund during a critical period of scaling in AuM.

The most effective redemption fee should therefore be applied at a predetermined level only in certain scenarios in the discretion of the manager. It should also have flexibility to be applied differently across share classes to ensure appropriate tailoring for the fund’s liquidity and

investor profile (e.g. higher redemption fees for institutional investors which could offset potentially larger redemption requests, compared to fees applied to individuals).

Swing and dual pricing

These LMTs are not at all suited to semi-liquid, private market fund strategies. As mentioned above, because semi-liquid funds hold, mostly, illiquid investments, it is not possible to get a pre-determined mechanism to adjust value of units based on liquidity. In some cases, the assets themselves cannot be disposed.

Anti-dilution levy

We would advocate that fees paid to the AIF by unitholders or shareholders based on repurchases within a certain period from the date of subscription (i.e. soft lock described above) should be considered as an available form of anti-dilution levy – but as currently drafted Recommendation 6 does not appear to contemplate this. This LMT is not at all suited to semi-liquid, private market fund strategies.

Because semi-liquid funds hold mostly, illiquid assets, it is not possible to set a pre-determined mechanism on adjusting NAV reflecting cost of liquidity and the fee could be almost 100% of the subscription price.

AIFMs should have the discretion:

- to implement fees to be charged above a pre-determined percentage of fund NAV to protect non-redeeming unitholders and shareholders from an AIF receiving outsized repurchases.
- to determine the appropriate manner of calculating such fees, whether swinging based on size of subscription, repurchase or redemption, or a fixed amount.

In exercising their discretion, AIFMs will have to consider, in collaboration with appropriate distribution and strategic partners, whether the AIF as a whole would benefit from such anti-dilution levies.

Examples of when such fees may be levied include:

1. charging a minimal fee with respect to subscriptions over a certain percentage of NAV to compensate existing investors for any reduction in returns resulting from the increase in liquidity that has not been deployed; and
2. a fee charged on individual repurchase requests exceeding a certain percentage of NAV which could likely tip aggregate repurchases over an AIF's pre-determined repurchase programme to the disadvantage of investors seeking smaller repurchases.

Such anti-dilution levy should be available for the AIFM to apply only to certain share classes where:

- deemed more appropriate for types of investors in those classes (e.g. professional or institutional investors); and
- segregation of such application would be in the best interests of the AIF as a whole (e.g. to segregate the potential implications of larger investments by professional or institutional investors from investments across the AIF's remaining non-professional investors).

Whilst paragraph 2 of Recommendation 3, Category 2 does provide some flexibility for semi-liquid OEFs to rely on quantitative LMTs, we have concerns that the wording of paragraph one of the same section may cause national competent authorities to impose restrictions that are

too narrow or otherwise take the discretion away from AIFMs. Another approach could bear the risk to create situations where those who have the most expertise to make the relevant determinations may not be able to do in the best interest of the fund and its investors.

Again, flexibility here should not be seen as a luxury to the manager but as a necessity for specific types of funds to be set up in the most appropriate way for all participants.

3. Are there any other LMTs or liquidity management measures commonly used by OEF managers?

Semi-liquid products already employ highly effective liquidity management techniques including but not limited to what is known as a "redemption programme". A redemption programme is a mechanism to cap redemptions in a given period (e.g. 5% of NAV per quarter, the "Cap"). If shareholders submit redemption requests and the value of those requests exceeds the Cap, the manager can, but is not required to, limit redemptions to, in this example, 5% of NAV in that quarter. The manager will typically redeem pro rata to each redeeming shareholders' shares/units, so that each investor has part of their redemption request satisfied. The Cap is typically sized in an amount that is similar to the value of liquid investments held by the fund.

We would argue this is a type of redemption gate, but it would be helpful if Recommendation 3 could clarify this fact and in particular that a permanent feature of the fund such as a redemption programme is an effective liquidity management tool.

Other Proposed Revised Liquidity Recommendations

7. Do you have any comments on any of the other Proposed Revised Liquidity Recommendations put forth in this document?

We disagree with the suggestion in Recommendation 6 that there are negative consequences associated with exclusive reliance on quantitative LMTs. As noted above, this is particularly restricting given that a number of LMTs are not suitable for semi-liquid, private market fund strategies. In addition, the relevant AIFM will be best placed to determine which suite of LMTs will be most appropriate, taking into account the investment strategy and targeted investors. This suggestion goes beyond what is required in AIFMD Level 1 text and would also create a discrepancy with the rules set under the ELTIF regulatory technical standards.