

# ESMA consults on Liquidity Management Tools

25 July 2024

## Introduction

On 8 July 2024, ESMA published two separate consultation papers relating to the use of liquidity management tools (**LMTs**) by UCITS funds and open-ended AIFs, namely:

1. draft **regulatory technical standards** on the characteristics of LMTs (**Draft RTS**); and
2. draft **guidelines** on the selection and calibration of LMTs (**Draft Guidelines**).

In this briefing, we highlight key elements of ESMA's proposals which we encourage all Irish fund management companies and their relevant delegates to consider.

Feedback to the consultation should be provided to ESMA before the deadline of **8 October 2024**.

## Background

One of the key reforms to the UCITS and AIFMD frameworks made by the recently published **Directive (EU) 2024/927 (Omnibus Directive)** is the introduction of the mandatory use of at least **two** LMTs by all UCITS funds and open-ended AIFs<sup>1</sup>. This obligation will apply to in-scope fund management companies from **16 April 2026**.

These LMTs must be selected from a list set down in the Omnibus Directive which comprise of (i) redemption gates, (ii) extension

<sup>1</sup> UCITS and AIFs established as money market funds are required to only select and use one LMT from the list set down in the Omnibus Directive.





of notice periods, (iii) in-kind redemptions, (iv) redemption fees, (v) swing pricing, (vi) dual pricing, (vii) side pockets and (viii) anti-dilution levies. In addition, in-scope fund management companies must have the ability to suspend subscriptions/redemptions and to apply side pockets in certain circumstances.

To date EU fund management companies have enjoyed discretion (subject to appropriate disclosure and any rules imposed by their home regulator) to define the key characteristics of any available LMT.

However, as part of ongoing efforts to have a harmonised approach throughout the EU, ESMA is now tasked with (i) preparing regulatory technical standards detailing the characteristics of each of the LMTs listed in the Omnibus Directive and (ii) preparing guidelines on the selection, calibration and activation/deactivation of such LMTs.

## Adaptation of existing LMT frameworks

All in-scope fund management companies will be required to assess their existing LMT arrangements against the requirements imposed under the new framework to determine if they align with the new rules.

For example, under current Irish rules, it is possible to satisfy a redemption request through an in-kind redemption. However, under the revised rules, it will not be possible to satisfy a retail investor's redemption request through an in-specie transfer of assets.

In addition, the application of redemption gates applied under current Irish rules also differs from the criteria proposed by ESMA. Under Irish UCITS rules, gates can be applied where redemption requests received on the relevant dealing day exceed 10% of the net asset value of the fund. In contrast, ESMA has asked for feedback on whether the activation threshold should be set at 5% for daily **net** redemptions and at 10% for cumulative **net** redemptions received during a week for daily dealing funds.

UCITS management companies may also choose to update their existing LMT arrangements to avail of additional flexibility provided for under the revised UCITS framework which is currently not available under Irish UCITS rules. For example, the Central Bank of Ireland (**Central Bank**) will currently only allow Irish UCITS to establish side pockets for the purposes of dealing with Russian, Belarusian or Ukrainian sanctioned assets through the use of a clone fund<sup>2</sup>. However, under the revised UCITS framework, all UCITS funds will, subject to complying with the finalised rules, be able to use side pocket arrangements in exceptional circumstances where this is in the interests of the investors.

### Key Action Points

Liquidity risk teams should assess the new framework against their existing LMT framework and consider whether any of the proposals put forward by ESMA are problematic and if so, respond to the consultation papers before 8 October 2024.

<sup>2</sup> UCITS and AIFs established as money market funds are required to only select and use one LMT from the list set down in the Omnibus Directive.





## Selection of appropriate LMTs

Under the new framework, in-scope fund management companies will also be required to assess the appropriateness of each existing LMT for the relevant fund taking into account the specific criteria set down in the Draft Guidelines.

ESMA has suggested that fund management companies should consider the merit of selecting at least one quantitative-based LMT<sup>3</sup> and at least one anti-dilution tool or “ADT”<sup>4</sup>. It has also advised that consideration should also be given to selecting one ADT LMT for use in normal market conditions and one quantitative LMT for use in stressed market conditions. It has also cautioned against the simultaneous activation of more than one ADT (such as swing pricing and anti-dilution levies) as this could lead to duplicating impacts.

ESMA has also identified that some of the LMT may be specifically suited to a particular type of fund as well as setting out guidelines on the type of funds which certain LMTs may not be suitable for. By way of example, it has suggested that anti-dilution levies are suitable for funds which invest in less liquid assets (such as high yield bonds and small cap equities) and that swing pricing is more suitable for funds whose underlying assets are actively traded.

Interestingly, the Draft Guidelines seem to introduce an element of flexibility and pragmatism into the use of LMT. For example, ESMA has indicated that it should be possible to suspend dealing or apply side-pockets even in circumstances where investors have not been made aware of the possibility of such tools being used in the fund’s offering documents provided that such arrangements comply with the requirements outlined in the Draft RTS and Draft Guidelines. Similarly, it has proposed that it should be possible to implement a swing factor beyond that originally disclosed to investors in fund documentation in stressed market conditions provided that certain safeguards are in place, including an obligation to be able to justify this approach and provide documentary evidence demonstrating that the factor applied was representative of the prevailing market conditions if required by the Central Bank.

Each fund management company will therefore need to assess the appropriateness of its existing LMTs for each relevant fund against the selection criteria set down by ESMA in its Draft Guidelines.

### Key Action Points

Liquidity risk teams should assess the LMT currently used to determine whether they are appropriate taking into account the recommendations put forward by ESMA in the Draft Guidelines. If they think those ESMA recommendations are inappropriate, feedback should be provided to ESMA by the deadline of 8 October 2024.

<sup>3</sup> Quantitative LMT include redemption gates, in-kind redemptions and extended notice periods

<sup>4</sup> Anti-dilution tools” or “ADTs” are price-based tools and include redemption fees, swing pricing, dual pricing and anti-dilution levies under which the final price received or paid by investors is adjusted



## Specific challenges for ETFs dealing in-kind

The Omnibus Directive provides that the use of redemptions in kind as an LMT shall only be activated (i) to meet redemption requests of professional investors and (ii) if the redemption in kind corresponds to a pro rata share of the assets held by the relevant fund. While the Omnibus Directive provides that passively managed ETFs can avail of a derogation from the requirements that redemptions in kind corresponds to a pro rata share of the assets held by the relevant fund, this derogation is not available to actively managed ETF funds.

Both **IOSCO** and the **FSB** in their recommendations on liquidity management in open-ended funds published in December 2023 clearly state that their recommendations do not apply to ETFs due to the fact that ETFs' structural features and liquidity management distinguish them from other open-ended funds.

It is important that ETF managers respond to both ESMA consultations to seek clarification that the requirements in relation the use of redemptions in kind (as provided for in the Omnibus Directive) do not apply to any ETF (whether passive or active) which is using redemptions in kind as part of its normal operating structure and which has not nominated this as an LMT for the purpose of the Omnibus Directive. We would also recommend that ETF managers review the Draft RTS and Draft Guidelines generally, including for example, the requirements around the use of swing pricing (which is increasingly used for ETFs which have unlisted as well as listed share classes).

### Key Action Points

Those managing ETFs should consider engaging with industry associations to ensure that the clarification referred to above is being sought at industry level (as well as by individual ETF issuers who are responding to the ESMA consultation papers).

## Focus on investor disclosures

Appropriate disclosure of use of LMTs to investors is a key focus of ESMA under its Draft Guidelines.

Unsurprisingly, under those Draft Guidelines, clear disclosures on the objectives and operation of LMTs must be provided in fund documentation which should explain to investors that the main purpose of those LMT is to facilitate the fair treatment of investors by protecting those who remain invested in the fund from bearing the costs generated by the subscription and redemption activities of other investors. The implications of LMTs in terms of liquidity costs or access to their capital should also be disclosed. ESMA has noted that such disclosures should help to "normalise" the use of LMT and increase the understanding of their functioning by investors.





Interestingly, ESMA has acknowledged that the provision of too much information to investors on the operation of LMT could lead to some investors being able to exploit first-mover advantage or “game” the mechanism to the detriment of other investors. As a result, the Draft Guidelines provide that fund management companies should carefully consider the level of detail and timing of disclosures so as to balance the benefits of transparency with the potential risk of unintended consequences. For example, while relevant details on the activation of swing pricing should be disclosed to investors, ESMA recommends that the actual activation threshold for swing pricing should not be disclosed in order to prevent first mover advantage.

In a new departure for Irish UCITS funds and introducing enhanced disclosures for AIFMs, ESMA has also proposed that it may be helpful for funds to disclose information on the historical use of LMT to investors via the fund’s financial statements or via a website. The objective of such disclosures would be to help investors to understand the potential cost implications of buying or selling shares in the fund at different points of time and the situations in which they would not be able to redeem their shares in the fund. Acknowledging the stigma effect or risk of front-running on the basis of such disclosures, ESMA has suggested that specific figures should not be disclosed. Instead, the focus of such disclosures should be on disclosing a range of factors that have been used. Alternatively, delayed disclosure after application should be considered.

### Key Action Points

If any of the proposed guidelines on disclosures, including the proposal to require ex-post reporting on the use of LMT to investors, are considered inappropriate, feedback should be provided to ESMA by the deadline of 8 October 2024.

## Role of the Depository

ESMA has proposed that the Draft Guidelines apply to depositaries who should be required to set up appropriate verification procedures to check that managers have in place documented procedures for LMTs. ESMA does not provide any further colour on its expectations so depositaries will be watching closely to see whether the finalised rules adopt a similar approach to that taken in the [ESMA Guidelines on Liquidity Stress Testing \(LST\)](#) under which it is made clear that the depository does not have to assess the adequacy of the LST programme and instead must simply confirm that such LST programme is in place.

### Key Action Points

Depositaries may want to respond to the consultation to advocate for more clarity on the scope of their role to be included in the finalised guidelines.

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## CONTACT US

If you would like to discuss the above in further detail or require assistance in responding to the ESMA consultation papers, please get in touch with your usual contact in Dillon Eustace or any of the authors listed below.



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