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RE: Public Comment on LMT Guidance - Consultation Report

We welcome the Consultation Report and commend the thorough analysis it contains. We support the stated scope of the proposed guidance that it is responsible entities that are best placed to manage the liquidity of their funds and that the role of the proposed guidance is to set out the factors and parameters that should be considered, and not to prescribe the use of specific tools or calibrations. It follows that the role of regulators should be to facilitate rather than impose specific liquidity management tools or prescribe their calibration.

In our view, the Consultation Report is clear about the purpose of anti-dilution mechanisms and what they can and cannot achieve, especially in the debate about financial stability. We must differentiate between potential first-mover advantage arising from asymmetry between the cost of redeeming from a fund and the true cost of selling the underlying assets, and the first-mover advantage arising from well-timed investment decisions about the future direction of financial markets. Swing pricing and other anti-dilution mechanisms can be effective in addressing the former but must not be used to inhibit the latter. This clarity underpins our comments which are focused around three key themes.

Firstly, it is essential to recognise that it is inherently fair to ensure the economic experience of investors as they exit or enter a fund is the same as if they traded the underlying portfolio of assets directly. In our view this perspective is a better representation of the pricing mechanism as a means of protecting the interests of remaining investors from the effects of the transacting investors actions, and may help to assuage investors' fears about being penalised by the cost of liquidity. This principle pervades our answers and is particularly pertinent in relation to disclosures and addressing negative perceptions.

Secondly, the overriding obligation should be to monitor dilution and take steps to mitigate material dilution. This means policymakers and regulatory authorities need make available a range of anti-dilution LMTs but should not prescribe their use or specify their detailed calibration.

Finally, the well-crafted proposed guidance on governance arrangements should not be compromised by disproportionate technical methodologies. It needs to be recognised that transacting investors are contributing the 'in-principle' cost rather than the 'actual' cost of dilution. Therefore, care should be taken in the design of procedures to ensure that any additional operational complexity is justified by a commensurate improvement in the mitigation of material investor dilution.

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Yours sincerely

A handwritten signature in black ink, appearing to read 'M. Sherwin', written in a cursive style.

Mark Sherwin
Senior Adviser, Financial Reporting

Anti-dilution Liquidity Management Tools

RESPONSE TO CONSULTATION

About the Investment Association

The Investment Association (IA) champions UK investment management, a world-leading industry which helps millions of households save for the future while supporting businesses and economic growth in the UK and abroad. Our 270 members range from smaller, specialist UK firms to European and global investment managers with a UK base. Collectively, they manage \$13.5 trillion for savers and institutions, such as pension schemes and insurance companies, in the UK and beyond. 46% of this is for overseas clients. In particular, UK-based firms manage \$5.5 trillion for investment funds domiciled primarily in the UK (35%), Ireland (33%), and Luxembourg (15%). The UK asset management industry is the largest in Europe and the second largest globally.

Executive Summary

In international terms, the UK is relatively unusual in the scale of its use of anti-dilution tools, and therefore provides a very useful test case for the current global policy and regulatory debate. Dual pricing was the only permitted approach until single pricing was introduced at the end of the twentieth century. Now over 85% of UK-domiciled funds under management is subject to either swing pricing or dual pricing with almost all of the remainder retaining the ability to apply a dilution levy. In Luxembourg, there is almost universal adoption of swing pricing by firms of UK, US, or Swiss origin.

In October 2022 the IA published a paper *Enhancing Fund Pricing*¹ which includes a set of practical recommendations on the application of anti-dilution mechanisms that align closely with the IOSCO proposed guidance on calibration, activation and governance of anti-dilution LMTs. It informs and provides the evidence for the statements made in this consultation response.

Our answers to the specific questions raised in the Consultation Paper lead us to recommend the following amended proposed guidance:

Proposed Guidance 1: Responsible entities should have appropriate internal systems, procedures and controls in place at all times to monitor dilution and, where appropriate, to mitigate material investor dilution 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.

Proposed Guidance 2: [deleted]

Proposed Guidance 3: Responsible entities should be able to demonstrate to authorities (in line with the authorities' supervisory approaches) that their internal systems, procedures and controls are appropriate and sufficiently prudent so as to mitigate material dilution in both normal and stressed market conditions.

Proposed Guidance 4: 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 material dilution impact in the fund.

Proposed Guidance 5: Responsible entities should have adequate and appropriate governance arrangements in place for their liquidity risk management processes, including clear decision-making processes for the use of anti-dilution LMTs.

Proposed Guidance 6: Responsible entities should publish a clear explanation of dilution, how dilution affects the value of their investment over time, and the policies the fund manager has in place to mitigate

¹ The Investment Association. (2022). [Enhanced Fund Pricing](#).

dilution. Where appropriate, this should include an explanation of any anti-dilution LMTs employed and the fund manager’s policies for operating those LMTs.

PROPOSED GUIDANCE 1 – OVERALL FRAMEWORK

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 support the stated scope of the proposed guidance that it is responsible entities that are best placed to manage the liquidity of their funds and that the role of the proposed guidance is to set out the factors and parameters that should be considered, and not to prescribe the use of specific tools or calibrations. It follows that the role of regulators should be to facilitate rather than impose specific liquidity management tools or prescribe their calibration.

The proposed guidance would be better supported by an overall objective articulated by reference to the desired investor outcome – to help the effective protection of investors from material dilution – rather than to help increase the use of certain tools. This would guard against the use of poorly implemented or less appropriate tools be regarded as a success and focus firms on addressing the source of potential harm.

We consider that all the critical elements of a robust anti-dilution framework are captured in the Consultation Report. We also support the observation that the cost of liquidity in the context of this proposed guidance is limited to the transaction costs for trading the underlying assets and does not include other valuation issues as highlighted on page 11. These are important but separate issues that need to be addressed by operational and valuation procedures independent of the application of any anti-dilution LMTs, notwithstanding that they may reside within the same governance structure.

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 recommend amending two aspects of proposed guidance 1 and otherwise support it:

Firstly, the arrangements should be specified as being in place “to mitigate material investor dilution” in order to avoid the need for overly sophisticated procedures targeting insignificant dilutive effects. It should be possible for fund managers to analyse the potential for investor dilution and conclude there are no reasonably foreseeable circumstances (including periods of market stress) where dilution will be sufficiently material to support the need for an anti-dilution LMT.

Secondly, the arrangements should be intended only to mitigate investor dilution and not be articulated as being to address potential first-mover advantage. Effective dilution mitigation removes a specific incentive for investors to redeem first in order to avoid incurring trading costs caused by transacting investors. Any reduction in systemic risk due to first-mover advantage is a consequence of effective dilution mitigation not an objective. This incentive to avoid being diluted is one of several potential sources of first-mover advantage and it is essential that anti-dilution LMTs are not used to lock investors into a fund or penalise them for exiting when they are motivated to move first based on judgements about prevailing or anticipated market conditions.

Therefore, our preference for proposed guidance 1 would read as follows:

Proposed Guidance 1: Responsible entities should have appropriate internal systems, procedures and controls in place at all times to monitor dilution and, where appropriate, to mitigate material investor dilution 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.

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.

We agree with the exclusion of exchange-traded funds and money market funds from the scope of the proposed guidance. We consider the proposed guidance to be appropriate for other types of open-ended funds where potential dilution is sufficiently material (see our answer to question 2) and given the acknowledgement that the critical elements may vary according to the nature of certain funds. IOSCO might also consider clarifying that the guidance is relevant to funds aimed at all types of investors. Notwithstanding the current extensive use of anti-dilution LMTs by UK fund managers across a wide range of funds domiciled both in the UK and other jurisdictions, other organisations are better placed to comment on whether the guidance is proportionate for responsible entities in their jurisdictions.

PROPOSED GUIDANCE 2 – TYPES OF ANTI-DILUTION LMTS

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.

Yes, in our view the guidance identifies all commonly used anti-dilution LMTs. We are aware of two further less commonly used non-price-based anti-dilution LMTs that mitigate investor dilution by avoiding the need to sell underlying assets to raise cash to pay redemptions.

Firstly, in-kind redemptions – this approach delivers underlying assets to the investor who will need to sell those assets to raise cash and thereby will incur transaction costs on their own account. However, the inability of most investors to take delivery of such assets means this approach is rarely used in practice.

Secondly, box management – this approach recycles fund units without the need to trade underlying assets to raise cash. It requires the fund manager to commit its own capital to pay out redemptions and hold the redeemed fund units in anticipation of selling them to future subscribing investors. In order to provide this service, a fund manager needs to recover the cost of capital committed by imposing a bid-ask spread in the unit price. This makes it commercially viable only when used in conjunction with dual pricing. Once a common approach in the UK, the introduction of rules by the Financial Conduct Authority in 2018 requiring all proceeds from a bid-ask spread to be paid into the fund made it uneconomical to provide such a service.

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?

Most significantly we agree that the key differentiator of the effectiveness of the various anti-dilution LMTs is their responsiveness to changing market conditions, particularly the onset of stress episodes, rather than the specific type of anti-dilution LMT. We have the following observations about the descriptions of the identified anti-dilution LMTs:

‘Valuation at bid or ask prices’ effectively describes a form of ‘swing pricing’ in which the swing factor is calculated daily by reference to the bid and ask prices of the underlying assets. Therefore, we would regard these as a single anti-dilution LMT with different calibration characteristics ranging from a standard factor through increasingly dynamic review frequencies up to a daily recalculation of the factor based on underlying assets’ bid and ask prices.

The different approaches to implementing ‘dual pricing’ exhibit the same characteristics – the ‘adjustable spread’ approach can have calibration characteristics ranging from a standard spread through increasingly

dynamic review frequencies up to a daily recalculation of the spread based on underlying assets' bid and ask prices.

'Valuation at bid or ask prices' and 'dual pricing' both reference portfolio valuations based on bid and ask prices of the underlying assets. In both cases it would be more accurate to describe the price for subscribing (redeeming) investors as being the ask (bid) price plus (minus) explicit transaction costs.

'Dual pricing' as described represents a scenario in which investors trade units directly with the fund. In the traditional UK model, investors traded units with the fund manager and the fund manager would periodically issue or cancel fund units for its own account to manage the size of its stock of units (the manager's box). As described in our answer to question 4, this box employed the manager's capital to reduce the need for the fund to absorb or realise cash and thereby reduced the need to trade underlying assets. Operation of a manager's box requires two pairs of prices – those calculated by reference to the bid and ask prices of the underlying assets at which the fund manager would cancel or issue fund units, and those calculated with a smaller spread sufficient to cover the manager's cost of capital at which the fund manager would transact with investors.

6. Do you support the proposed guidance 2? 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?

In general terms we are not clear why both proposed guidance 1 and 2 are required as they both appear to cover broadly the same principle – that investor dilution should be mitigated. More specifically, we do not agree with imposing the use of at least one anti-dilution LMT – the objective should be the effective protection of investors from material dilution. As set out in our answer to question 2, it should be possible for fund managers to analyse the potential for investor dilution and conclude there are no reasonably foreseeable circumstances (including periods of market stress) where dilution will be sufficiently material to support the need for an anti-dilution LMT. We agree with the exclusion of exchange-traded funds and money market funds from the scope of the proposed guidance.

Therefore, our preference would be to remove proposed guidance 2 entirely in favour of our modified proposed guidance 1 as set out in our answer to question 2.

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 that responsible entities are best placed to manage the liquidity of their funds (see our answer to question 1) and should therefore be able to determine the most appropriate basis for estimating the cost of liquidity. Nevertheless, we agree that the estimated cost of liquidity is generally the expected transaction costs for trading a pro-rata slice of the entire portfolio and this should underpin the calibration of the anti-dilution LMTs. We also agree that this does not necessarily mean the fund manager will actually trade a pro-rata slice. This approach is inherently fair because it ensures the economic experience of investors as they exit or enter a fund is the same as if they traded the underlying portfolio of assets directly – investors will be subject to transaction costs in line with their decision to buy, hold or divest.

The nature of effective anti-dilution LMTs in open-ended funds is such that investors will never transact at a price worse than the fair price for trading the underlying assets, and in some circumstances will receive a price that is better than that fair price. For example, a subscribing investor in a fund experiencing net redemptions will be 'rewarded' for reducing the pressure on the fund to sell underlying assets. In our view

this perspective is a better representation of the pricing mechanism as a means of protecting the interests of remaining investors from the effects of the transacting investors' actions, and may help to assuage investors' fears about being penalised by the cost of liquidity.

We agree that transaction costs comprise a relatively stable explicit component and a potentially more variable implicit component. The relative significance of these components should be the key determinants of the calibration of anti-dilution LMTs.

There are two components to proposed guidance 3. The first is really a definition of the cost of liquidity (i.e. dilution) and as such, would be better positioned as a definition rather than a point of guidance. The second part relates to the effectiveness of the calibration of the anti-dilution LMT and could be adapted to support the overall objective in proposed guidance 1.

Therefore, our preference for proposed guidance 3 would read as follows:

Proposed Guidance 3: Responsible entities should be able to demonstrate to authorities (in line with the authorities' supervisory approaches) that their internal systems, procedures and controls are appropriate and sufficiently prudent so as to mitigate material dilution in both normal and stressed market conditions.

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?

Many factors affect the cost of liquidity and it is the portfolio profiles and the circumstances of individual funds that drive differences across funds. The governance section of the Consultation Report seeks to ensure that policies and procedures are commensurate and appropriate for each fund and notes that different factors and calibrations will be applied in different situations. It follows that the proposed guidance should be seeking to ensure that the calibration of anti-dilution LMTs is appropriate and effective, rather than consistent, and this aligns with our views expressed in answering question 1 – that the objective of the proposed guidance should focus on supporting the effective mitigation of material dilution rather than simply increasing the use of anti-dilution LMTs.

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

Unlike other transaction cost components, the conceptual basis and practical mechanics for including market impact are debatable and challenging.

The Consultation Report establishes the expected transaction costs for trading a pro-rata slice of the entire portfolio as the estimated cost of liquidity regardless of whether the fund manager will actually trade a pro-rata slice, a position with which we agree (see our answer to question 7). Therefore, transacting investors are contributing the 'in-principle' cost rather than the 'actual' cost of dilution. This raises the question of whether transacting investors' contributions should be based on the pro-rated cost of normal-sized trades in each security or the potentially higher costs associated with larger trades.

In order to factor in market impact it will be necessary to consider what size of net redemption would give rise to a material cumulative market impact from assumed individual securities trades within a pro-rata slice of a diversified portfolio, potentially constructed within the boundaries of regulatory concentration limits. This question implies a more extreme set of circumstances is likely to be required before market impact becomes relevant.

The quantification of market impact is unique to a specific trade and depends on the volume and direction of trading in the security in the market at the time. It also depends on the trading strategy of the fund manager which will be designed to minimize any impact of the trade on the price. Fund managers will have experience of the effectiveness of their trading strategies in this respect and it will be necessary to take

account of this information in the calibration. This is likely to require direct involvement of the trading desks.

We would caution against a comparison of the original market screen price and the final executed price (referred to as slippage on page 16 of the Consultation report) as an indicator of transaction costs. This concept was originally designed as a means for trading desks to analyse their effectiveness at implementing investment decisions. However, its inclusion by European regulators as a component of transaction costs has been highly problematic.² Consideration of uncertainty about screen prices due to fixed income securities being quoted on an indicative rather than binding basis, or fast-moving markets in periods of stress, is a matter for valuation policies and procedures as noted on page 11 of the Consultation Report and should not form part of the application of anti-dilution LMTs.

In the UK, the traditional approach was to postulate the cost of creating or cancelling a single unit of a fund and this leads to a presumption that the estimated implicit portion of the cost of liquidity should include only the spread for trading normal-sized trades and therefore excludes any market impact. Inclusion of market impact is still rare in the UK.

Whilst responsible entities may regard market impact as relevant in some circumstances, we consider the practicalities sufficiently challenging so as to render the mandatory consideration of market impact in the calibration of anti-dilution LMTs inappropriate. The final guidance could include a discussion of market impact in the context of estimating implicit costs but should not set expectations about its inclusion.

In the interests of a proportionate approach to encouraging the use of anti-dilution LMTs, and making them accessible to first-time adopters, our preference would be to remove reference to market impact from proposed guidance 3 entirely.

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?

We agree (with one technical exception) with the analysis in the Consultation Report about the ability of each anti-dilution LMT to incorporate the cost components. In particular, the analysis reflects the responsiveness of each tool to changing market conditions, particularly the onset of stress episodes. As detailed in our answer to question 5, both dual pricing and swing pricing can be calibrated equally effectively on a spectrum of most responsive (based on the use of daily bid and ask prices of the underlying assets) to least responsive (based on fixed estimates of spreads) in all cases including any explicit costs.

We agree that caps or restrictions are not consistent with the overriding objective of mitigating investor dilution in both normal and stressed conditions.

Our technical exception relates to the assertion that the ‘adjustable spread’ approach to dual pricing can be more dynamic than the approach based on bid and ask prices – this is wrong, it can only be less or equally dynamic because the use of bid and ask prices is the most dynamic end of the calibration spectrum.

² The embedded assumptions of slippage make it unreliable and capable of generating ‘negative’ transaction costs due to inclusion of market movements unrelated to the trades in question. Although such negative figures are technically accurate according to the prescribed calculation methodology, they are counter-intuitive. A number of fund market participants are wary of transaction cost metrics calculated in this way, and the methodology is so confusing to investors that the EU authorities have now amended their disclosure rules so as to ignore implicit costs if they turn out to be negative.

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?

We do not have first-hand experience of working with subscription or redemption fees given the near-universal use of other anti-dilution LMTs in the UK.

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 in our answer to question 5, the effectiveness of the various anti-dilution LMTs is their responsiveness to changing market conditions, particularly the onset of stress episodes. The most responsive mechanisms will be those that employ the most dynamic calibration methodologies based on the daily bid and ask prices of the underlying assets. A tiered approach can serve as a reasonable proxy for a truly dynamic calibration by establishing a series of adjustment factor tiers but will require a complex set of triggers linked to market conditions and activation thresholds. Care should be taken to ensure that the additional operational complexity involved is justified by a commensurate improvement in the mitigation of material investor dilution.

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?

As noted in our answer to question 5, the effectiveness of the various anti-dilution LMTs is their responsiveness to changing market conditions, particularly the onset of stress episodes. Therefore, it is essential that the calibration is not constrained by arbitrary limits imposed by the investment vehicle. The cost of liquidity is a function of the markets which the investment strategy targets, not the vehicle used to access those markets, and the fund manager's ability to attribute those costs appropriately should be unfettered.

In our view, negative perceptions of anti-dilution LMTs stems the starting point of how they are presented. If you start from the presumption that the fair price to buy and sell fund units is based on the mid-price of the underlying securities, then the adjustment factor comes to be regarded as a charge that must be quantified and its magnitude controlled.

The alternative is to start from the position that the fair price to trade fund units is based on the cost of actually buying or selling the underlying assets – ensuring the economic experience of investors as they exit or enter a fund is the same as if they traded the underlying portfolio of assets directly. This ensures the fair treatment of all investors.

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

We agree that any such disclosures should be indicative of historical adjustments and not presented as if they were a cap or restriction on the magnitude of future adjustments. We consider caps or restrictions not to be consistent with the overriding objective of mitigating investor dilution in both normal and stressed

conditions and their use in investor disclosures can contribute to the negative perceptions discussed in our answer to question 13.

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?

Yes, it is appropriate. The calibration can only be made based on expert judgements using the information available at the time taking account of the factors indicated on page 19 of the Consultation Report. Such information and judgements should be appropriately recorded and scrutinised. Such judgements should not be called into question due to the emergence of additional information not available at the time the judgement was made.

PROPOSED GUIDANCE 4 – APPROPRIATE ACTIVATION THRESHOLD

16. What are the appropriate factors to consider in setting the activation threshold so that anti-dilution 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?

The Consultation Report provides a good analysis of the factors that should be considered in setting activation thresholds and we agree with proposed guidance 4 as presented. We agree that thresholds should not be set too high but we do not agree that there is a problem if they are set too low. As set out in our answer to question 7, the estimated cost of liquidity is the expected transaction costs for trading a pro-rata slice of the entire portfolio and this approach is inherently fair because it ensures the economic experience of investors as they exit or enter a fund is the same as if they traded the underlying portfolio of assets directly. It remains fair regardless of whether an investor redeems when the fund experiences heavy net redemptions that would cause material dilution at that point in time or only modest net redemptions that might have an immaterial dilutive effect in isolation but would contribute to a more significant cumulative effect over time.

Dual pricing and full swing pricing (i.e. swing pricing operated such that the price is always swung in response to subscriptions or redemptions regardless of their magnitude) operate without an activation threshold and ensure protection from dilution is always provided to existing and ongoing investors regardless of any judgement about materiality. Nevertheless, partial swing pricing is the most common approach and the main reasons for its use are to reduce volatility in the unit price, and to target only material dilution when cash is used to manage lower levels of redemptions. This can work well in normal conditions with both inflows and outflows as cash received from inflows replenishes cash balances depleted by paying redemptions.

However, partial swinging carries the risk of being unresponsive to a shift to persistent outflows when it will become necessary to liquidate fund assets in order to maintain an appropriate cash balance. In these conditions the cash balance serves only to defer the dilutive effect and if the swing threshold is set too high, the dilution caused by these liquidations can accumulate and become material.

One approach to address this risk is to operate a semi-permanent swing that matches the trend of inflows and outflows over time, rather than responding to daily inflows and outflows on a mechanistic basis. This approach helps to reduce price volatility while minimising any dilution.

A further risk of the partial swing approach is that it may be unresponsive to changing market conditions such as a widening of market spreads. If the swing threshold is calibrated to a particular level of market spread in normal market conditions, it may fail to mitigate dilution in stressed conditions.

This risk can be addressed by ensuring processes are in place to reduce or remove the swing threshold in stressed conditions. However, a risk remains that such a response might take place only after the immediate stress peak had passed.

Another approach is to set the threshold by reference to a maximum level of dilution tolerance. The swing factor is calculated to reflect the trading costs that cause dilution and can therefore be considered as a measure of the dilutive effect of each unit of outflow. Assuming the swing factor calculation is quick to respond to changing conditions, this gives rise to a more dynamic threshold that is responsive to the onset of periods of stress.

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?

Activation thresholds do carry the risk of trigger effects. This is likely to be more pronounced in anti-dilution LMTs that are activated in response to the size of individual investor flows where an investor with knowledge of the threshold can deal in quantities below the threshold. Where activation is in response to the cumulative net flows of many investors, it is harder for any single investor to game the mechanism.

PROPOSED GUIDANCE 5 – GOVERNANCE

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?

We agree that the proposed governance and oversight arrangements include all the essential elements and are proportionate. Therefore, we support proposed guidance 5 as presented. We note that the Consultation Report considers both the conceptual approach that it is important to protect investors from material dilution and the technical detail concerning the incorporation of the various components of transaction costs in the calibration of adjustment factors. It is essential that pursuit of spurious technical precision does not weaken the governance framework.

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

We consider the governance and oversight arrangements in the Consultation Report to be comprehensive.

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 do not agree with proposed guidance 6 and consider the disclosure regime set out in the Consultation Report to be unhelpful. As set out in our answer to question 7, it is inherently fair to ensure the economic experience of investors as they exit or enter a fund is the same as if they traded the underlying portfolio of assets directly. The nature of effective anti-dilution LMTs in open-ended funds is such that investors will never transact at a price worse than the fair price for trading the underlying assets, and in some circumstances will receive a price that is better than that fair price. For example, a subscribing investor in a fund experiencing net redemptions will be 'rewarded' for reducing the pressure on the fund to sell

underlying assets. In our view this perspective is a better representation of the pricing mechanism than the belief that transacting investors are being penalised by a pricing adjustment made solely in the interests of protecting the interests of remaining investors from the effects of the transacting investors' actions.

In our view it is unhelpful to investors to factor anti-dilution adjustments into their investment decisions as if they were costs. They would be better served by an explanation of dilution, how dilution affects the value of their investment over time, and the policies the fund manager has in place to mitigate dilution.

The disclosures as set out fuel the negative perception of anti-dilution LMTs. Our preference for a more positive construct of proposed guidance 6 would read as follows:

Proposed Guidance 6: Responsible entities should publish a clear explanation of dilution, how dilution affects the value of their investment over time, and the policies the fund manager has in place to mitigate dilution. Where appropriate, this should include an explanation of any anti-dilution LMTs employed and the fund manager's policies for operating those LMTs.

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 anti-dilution LMTs or creating unintended consequences? Further, how soon should this information be disclosed to investors?

In our view typical or illustrative anti-dilution adjustments should be disclosed to investors in the prospectus and it should be clear that these figures are no way binding or indicative of maximum future rates. In the UK, the total amount of the benefit of anti-dilution LMTs is required to be shown in a fund's financial statements.

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

The key risk is that the information made available enables an investor to manipulate the way they transact so as to alter their contribution to the mitigation of dilution. Therefore disclosure should focus on the policies for operating any anti-dilution LMT and information about the activation thresholds or other operating parameters should not be made available.

OVERCOMING BARRIERS AND DISINCENTIVES

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

The principle of protecting ongoing investors from dilution is deeply embedded in the history and culture of the UK fund industry, both in respect of domestic funds and overseas funds managed from the UK. As such we consider it is for other jurisdictions to comment on the barriers and disincentives to the implementation of anti-dilution LMTs.

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?

The principle of protecting ongoing investors from dilution is deeply embedded in the history and culture of the UK fund industry, both in respect of domestic funds and overseas funds managed from the UK. As such we consider it is for other jurisdictions to comment on solutions to the barriers and disincentives to the implementation of anti-dilution LMTs.

As set out in our answer to question 7, the nature of effective anti-dilution LMTs in open-ended funds is such that investors will never transact at a price worse than the fair price for trading the underlying assets, and in some circumstances will receive a price that is better than that fair price. For example, a subscribing investor in a fund experiencing net redemptions will be 'rewarded' for reducing the pressure on the fund to sell underlying assets. In our view this perspective is a better representation of the pricing mechanism as a means of protecting the interests of remaining investors from the effects of the transacting investors' actions, and may help to assuage investors' fears about being penalised by the cost of liquidity.

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 principle of protecting ongoing investors from dilution is deeply embedded in the history and culture of the UK fund industry, both in respect of domestic funds and overseas funds managed from the UK. As such we consider it is for other jurisdictions to comment on the implications of barriers and disincentives for the implementation of anti-dilution LMTs.

OTHER QUESTIONS

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

We have no other comments on the proposed guidance.