Liquidity Management Tools: New rules for open-ended alternative investment funds

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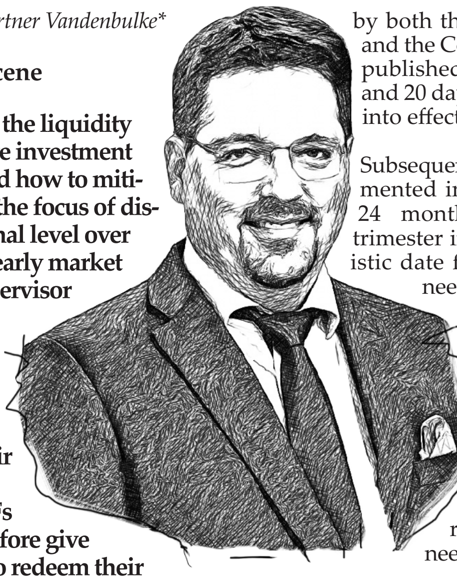

Setting the scene

The risks attached to the liquidity profile of alternative investment funds ("AIFs") – and how to mitigate them – have been in the focus of discussions on an international level over the last few years. In its yearly market reports, the European supervisor ESMA regularly mentioned these; the Financial Stability Board, the European Systemic Risk Board and IOSCO have also made it a topic in their own reporting. The main concern is that certain AIFs are open-ended and therefore give investors the possibility to redeem their units at a certain frequency, while the portfolio they invest in is fairly illiquid and cannot be sold in that timeframe. This so-called liquidity mismatch is identified as a risk from two perspectives: For investors because they cannot exit as they expect and resulting fire sales might drive down the value of the portfolio; for the public because a mass excodus of investors could cause a systemic risk for the markets, as 65% of all AIFs have an open-ended structure.

These concerns have, however, also been criticised: The assumption that all investors of an AIF would redeem at once appears unrealistic, in particular as investors in AIFs are for a large part institutional investors with a long-term horizon. Also, during the last crises (such as the COVID pandemic and the Ukraine war), no systemic or even large scale issues with fund redemptions could be noticed.

Be that as it may, such concerns have now been integrated into the revised AIFM Directive, where specific rules on so-called liquidity management tools ("LMTs") for open-ended AIFs are set out. While it is surprising to observe that there is little differentiation between AIFs and UCITS (for which the new directive introduces the same LMTs) in spite of a vastly dissimilar investor base, this should probably be seen as regulatory convergence which – whether justified or not – is one of the objectives of the new directive.

The new rules will not become binding immediately. Although the directive has been approved by both the European Parliament and the Council, it still needs to be published in the official journal and 20 days thereafter it will come into effect.

Subsequently it needs to be implemented into national law within 24 months, so that the first trimester in 2026 should be a realistic date for when the new rules need to be complied with.

AIFMs and initiators of open-ended AIFs should nevertheless start to get familiar with them in order to determine whether fund documentation that is existing or currently being drafted needs to be adapted.

Liquidity Management Tools under the revised AIFM Directive

The first thing to note is that the rules described in the following only apply to open-ended AIFs. Such term is defined in the EU Regulation 694/2014 as an AIF the units of which can be redeemed by its investors before it is liquidated.

It is therefore quite broad and does not distinguish between AIFs that, in practice, are sometimes referred to as semi-open-ended as they only allow redemptions after a certain period of time (lock-up) or with very long notice or settlement periods. An AIF however where an exit prior to its liquidation can be requested, but where the fulfilment of such request is entirely at the discretion of the fund itself or its AIFM should not be caught by the new rules.

The new directive sets out a list of 9 different LMTs: (1) The suspension of (in particular) redemptions, (2) redemption gates that temporarily limit redemptions to a certain percentage of the AIF's assets, (3) the extension of notice periods for redemptions, (4) the levying of a redemption fee to compensate non-redeeming investors, the procedures of (5) swing pricing and (6) dual pricing, (7) the payment of an anti-dilution levy, (8) redemptions in kind and (9) the establishment of side pockets.

Although this was a controversial issue during the negotiations of the directive and despite the fact that there is no explicit statement to this effect, it is apparent from several provisions in the new directive that this list is not exhaustive and other, more appropriate LMTs can be chosen in addition to those mentioned. This is particularly reassuring as a number of these LMTs are not relevant for certain asset classes, or in the case of dual pricing not really used in Europe at all. In fact, from the LMTs on the new list only redemption gates and the possibility of an extension of the notice periods are widely in use.

Other LMTs which can also be observed are for example (i) substantial lock-up periods that are put in place, (ii) making the execution of redemptions conditional to sufficient liquidity, (iii) significantly delaying the payout of asset sales, (iv) redemption fees that are progressive depending on the time a redemption is requested or (v) financing redemptions through temporary credit lines. The possibility of a secondary market for the AIF's units, by offering them to existing investors or third parties, is also quite common.

Two out of numbers (2) to (8) mentioned hereabove will have to be chosen by the AIFM, and the details of their application set out in the AIF's internal rules. These two cannot be numbers (5) and (6), and in addition the first (suspension) and last (side pockets) must always be possible measures to be taken – therefore taking the number of compulsory LMTs to a total of four.

During the drafting and negotiation process of the directive it was also contemplated to extend the possibility for local regulators to substitute themselves to the AIFM and activate a number of LMTs directly. This was fortunately averted, and the directive mentions in several places that the LMTs are the primary responsibility of the AIFM. The existing possibility for local regulators to suspend the issue and redemption of AIF units (currently article 46 (2) (j) of the AIFM Directive) was kept and slightly reformulated to only apply under exceptional circumstances where there are risks to investor protection or financial stability.

The possibility to proceed to redemptions in kind – number (8) – is reserved to professional investors, and these have to correspond to a "pro rata share of the assets" of the relevant AIF, except if it is an ETF or the AIF is only marketed to professional investors. The meaning of this provision is not quite clear: While the intention behind such rule – to prevent that the redeeming investor simply receives all of the most liquid assets of the AIF and consequently further redemptions become much more difficult – is understandable, it would be impossible for most AIFs to pay out a redeeming investor with some percentage of each asset that is held in its portfolio.

Another issue in practice will be to distinguish between the tasks of the AIFM and those of the AIF itself (or its general partner for example). Some LMTs such as the suspension of redemptions, the decision to use a gating provision or the establishment of side pockets are part of the corporate functions of the AIF and therefore not typically performed by the AIFM. This could however be solved by contractually delegating more powers to the AIFM.

In line with the ever increasing trend to multiply documentation requirements, the AIFM has to establish detailed policies and procedures for what the directive calls "activation and deactivation" of each LMT. These also need to be submitted to the home state regulator of the AIFM. Of course there also exist new reporting duties: The activation or deactivation of an LMT needs to be notified to the AIFM's home state regulator; for suspensions of redemptions and side pockets this even has to be done before such LMT is deployed.

A notification is not necessary if the LMT is used "in the ordinary course of business" which is a rather vague notion that can be expected to encourage regulators to consider anything not explicitly mentioned in fund documents as out of the ordinary.

The new rules are, in general, fairly granular in nature which will add complexity to complying with them in practice, and will restrict flexibility to deal with future challenges that cannot be foreseen. It could also be criticised that – as is the case with the new rules on loan originating funds – the AIFM Directive drifts away from being a manager regulation and more towards detailed product regulation, which it was never conceived to be.

As is the norm nowadays, the new directive will be supplemented by even more regulatory details to be drafted by ESMA: Regulatory Technical Standards ("RTS") with further specifics about the characteristics of the LMTs, as well as guidelines on the selection and calibration of the LMTs. Both should be developed within 12 months of the entry into force of the directive, and therefore be available before the new rules become applicable.

It can be hoped that both will be short and principle based rather than very granular and prescriptive. The wide range of asset classes and strategies would make the latter very difficult to work with in practice, where it is often necessary to quickly adapt to market conditions.

* https://www.vdblaw.com/