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Over-arching views regarding the ESMA LMT consultations

Introduction

INREV, together with AREF[1] and other associations have developed guidance and best practice standards for liquidity management and the tools that implement it for the non-listed real estate funds industry in Europe for many years. We have been pleased to be able to contribute to the discussion around liquidity management tools ("LMTs") in the past, including in the AIFMD review, and welcome the opportunity to share our experience and insights in the present consultation.

Members of AREF and INREV have collaborated to respond to these consultations. In addition to our responses to the questions, we would like to share the following over-arching observations and comments regarding the Draft Guidelines on Liquidity Management Tools of UCITS and open-ended AIFs ("Guidelines") and the Draft Regulatory Technical Standards on Liquidity Management Tools under the AIFMD and UCITS Directive ("RTS").

Principles-based approach

A stated objective of the Guidelines[2] and RTS[3] is to apply the 2023 IOSCO Guidance on anti-dilution tools. The IOSCO Guidance sets out a principles-based approach to LMTs to manage risk in situations in which there may be a liquidity mismatch between trading in the units of an open-ended fund ("OEF") and the liquidity of the underlying assets. In its 2023 Final Report, IOSCO stressed the diversity of OEFs and encouraged a non-prescriptive approach, emphasising that *"there is no 'one size fits-all' solution regarding liquidity risk management"*[4]. Below, we discuss the importance of this approach when considering the Guidelines and RTS in the context of OEFs investing in private real estate.

It is important to recognise as a starting point that not all OEFs give rise to a liquidity mismatch. A key concern of IOSCO was that *OEFs "generally offer short-term (often daily) liquidity to their investors, notwithstanding that the liquidity of fund investments varies*

[1] The Association of Real Estate Funds represents the UK real estate funds industry and has over 50 member funds with a collective net asset value of more than £50 billion under management on behalf of their investors. The Association is committed to promoting transparency in performance measurement and fund reporting through the AREF Code of Practice, the MSCI/AREF UK Quarterly Property Funds Index and the AREF Property Fund Vision Handbook.

[2] See para 2.2. of the Guidelines

[3] See para 2.2. of the RTS

[4] See section 1.1, pages 5-6 of the 2023 IOSCO Guidance

across different OEFs and over time for any particular fund" [5]. This is generally not the case for funds investing in real estate, for which the timing of subscriptions and redemptions is typically not daily and much more closely reflects the liquidity of the underlying assets. Funds investing in real estate (including housing and regeneration) are economically crucial to the future development and competitiveness of the European Union. Many of the long-term funds investing in these assets are evergreen vehicles that do not offer the short-term liquidity envisaged by IOSCO but nevertheless fall within the AIFMD definition of an OEF by providing redemption rights within the first five years of the life of the fund. This is equally true of many funds investing in infrastructure.

We note with approval that the Guidelines, in general, reflect a more principles-based approach to LMTs, which we hope would enable managers to maintain some discretion in applying LMTs to their products in a way that is appropriate to their investment strategy. We believe sufficient flexibility and discretion should be given to the manager to utilise the combination of LMTs, which includes not impeding the continuing use of appropriate tools in the ordinary course of business to manage fund liquidity. As a result, we believe that the Guidelines should avoid laying down criteria, sequencing and methodologies for activating LMTs in too much detail. For example, in answer to question 7, by their very nature, "exceptional circumstances" are difficult, if not impossible, to predict and so having a definition of exceptional circumstances that could account for all possible scenarios is very difficult. The Guidelines should not prevent managers having sufficient flexibility to determine the best use and combination of LMTs in all circumstances.

In that regard, we also note, and agree with, the approach in 2.2.1 of the RTS paper which makes it clear that managers can utilise other LMTs, including (but not limited to) "soft closures" where a fund can be closed to new subscriptions without also suspending redemptions etc. The combinations of LMTs in existing OEFs have been developed and agreed to in negotiations between managers and their institutional investors, and those funds should be able to continue to apply those agreed terms, and should be able to adapt their liquidity management mechanisms in order to respond to market developments and evolving fund features. Institutional investors understand that real estate is a fundamentally illiquid asset class and focus on LMTs as part of their due diligence. INREV, as an industry organisation for investors in unlisted real estate vehicles has a standard, but comprehensive due diligence questionnaire for use by its members. For investments in OEFs, there are specific questions on liquidity management and non-dilutive unit pricing.

Unfortunately, the RTS itself, in contrast, strike us as relatively prescriptive and the detail assumes that underlying investments are in securities. If adopted in its current form, we see these adverse consequences in practice:

[5] See section 1.1, pages 3 of the 2023 IOSCO Guidance

1. *Curtailment of manager discretion*
   The RTS would significantly limit managers' discretion and would not necessarily operate as intended for investments in more inherently illiquid assets. While the list and most aspects of the LMTs on the list that must be made available are generally reasonable, we are concerned that their level of detail would result in them being relatively inflexible in practice.

2. *Reduction of EU competitiveness as a fund domicile*
   A divergence by the European Union from the principles-based approach of IOSCO will make EU member states less attractive as jurisdictions for the establishment of OEFs compared to other countries that do not gold-plate the IOSCO Guidance. Fund sponsors have an increasing "menu" of fund domiciles to choose from when establishing new fund products. Such gold-plating could deter managers from establishing new OEFs using EU structures and instead explore non-EU fund domiciles that are less LMT prescriptive.

3. *Unnecessary complexity & costs*
   For fund sponsors establishing and/or managing, global private real estate funds (where the investor-base is international), such funds often have an EU-fund sleeve. Complexity could ensue in the future where managers may need to navigate differing LMT approaches between EU and non-EU sleeves - especially if non-EU fund jurisdictions develop rules that do not align with the RTS in the future. Navigating such complexity may generate increased fund set-up and/or operating costs to be ultimately incurred by investors.

In our experience, fund strategies, structures and the assets held by the fund vary widely and LMTs need to be tailored in some instances. One shoe does not fit all feet and some principles-based flexibility can much better accommodate the specific liquidity needs of a fund. Therefore, we urge ESMA to adopt principles-based measures and best practice recommendations nearer to the Guidelines and avoid the prescriptive measures found in much of the RTS. If this isn't possible due to concerns regarding protecting retail investors, perhaps a principle-based approach could be used for funds for institutional investors, which have more knowledge and ability to protect themselves and, in fact, generally negotiate LMTs with managers in the fund development process.

"Normal" and "stressed" situations LMTs

The Guidelines and RTS seek to distinguish between "normal" and "stressed" situations. It is important to note that there are different types of stressed situations that may arise for some asset classes but not others. The IOSCO Guidance cite the example of fund suspensions following redemptions at the start of the Covid crisis in March 2020. However, unlike other asset classes, real estate funds did not generally experience a surge in redemptions. The issue was more of a practical one – with lockdowns limiting access to buildings, carrying out valuations and sales was impossible. This is important in setting rules on deferral or suspension of redemptions.

It is also important to distinguish between a full "suspension" and a deferral of redemptions as a feature of business-as-usual. As mentioned above, real estate funds do not generally provide the daily liquidity that is the main concern to IOSCO. Most commonly, dealing days for subscriptions and redemptions are quarterly, with two or more quarters to meet redemptions. Redemptions not met in a quarter will be deferred until the subsequent quarter. Some real estate funds have significantly less frequent redemption dates. There are examples of OEFs with liquidity points every fifth year.

Suspensions

We are concerned about the requirement for suspensions of subscriptions, redemptions and repurchases to be applied simultaneously/in parallel to all investors, albeit on a temporary basis. This is not standard practice in the industry where managers often have a broad power to suspend redemptions in a particular set of circumstances (for instance a material change in the general economic situation) if they determine doing so to be in the best interests of the fund, but without any corresponding curtailment of their ability to create more liquidity in the interests of all investors. The ability to continue where possible with established methods of liquidity management allows manager flexibility across asset classes and can significantly shorten the length of time that the LMTs need to be used.

As outlined in our comments above, it is important to distinguish between different causes of suspensions. In a situation where there is such fundamental uncertainty over valuation that it is impossible to calculate the net asset value per unit at which units will be issued or cancelled, it is entirely logical to suspend both redemptions and subscriptions, and this is reflected in the documents of many funds. On the other hand, if it is merely that the level of net redemptions exceeds available cash to meet redemptions, it would be illogical for the reasons set out above not to allow subscriptions to continue.

It is typical in real estate funds for the manager to have the flexibility to meet redemptions over a number of quarters. Unmet redemptions are deferred to subsequent quarters. This is a feature of normal business-as-usual for funds investing in fundamentally illiquid assets rather than something that only happens in extreme circumstances. The exact mechanics and timing are set out in the fund documents and will usually be a major focus of attention by institutional investors during their due diligence.

Inconsistencies with LMTs in ELTIF 2.0

Another concern we have is the clarity and consistency of the interplay between LMT provisions adopted in ELTIF 2.0 and the measures proposed in the Guidelines and RTS. An ELTIF manager may select and implement at least one anti-dilution mechanism (in addition to notice periods): anti-dilution levies, swing pricing and redemption fees. Whereas under AIFMD2, the AIFM has to select at least two LMTs (from Annex V points 2-8, that is: redemption fee, swing pricing, dual pricing, anti-dilution levy, redemption gates, extension of notice periods and redemptions in kind). Given that AIFMD 2 liquidity and risk management provisions will need to be read alongside the ELTIF requirements, it would be helpful to clarify that an ELTIF manager does not also have to comply with the AIFMD Guidelines and RTS rules on LMT selection/characteristics. We note that there are various other detailed rules an ELTIF manager is subject to e.g. redemption size limit, notice period to redeem, minimum holding/lock up period and redemption frequency and that an AIFM that is not an ELTIF manager is not.

Unnecessary costs

A final overarching concern is the potential for unnecessary costs being imposed on a large part of the funds industry by the failure to grandfather funds for institutional investors that have LMTs in their terms that were developed and agreed to in negotiations between managers and their investors. Moreover, these LMTs must always be consistent with managers' fiduciary and risk management obligations. Requiring them to open up their fund documentation to insert or modify LMTs in ways that investors did not deem necessary before investing is a clear case of cost with no real benefit and furthermore creates a drag on fund returns that ultimately hurt investors. To alleviate the cost and administrative burden for both investors and managers, we suggest:

1. *Material Change Notification* - It would be helpful if any changes made to information disclosed to investors in order to supplement liquidity management provisions pursuant to the amended legislation and guidance do not constitute a material change for which member state regulators require notice of; and

2. *Consenting existing investors in customised vehicles* – It would be useful to defer the requirement to implement the LMT regime in existing real estate funds that (i) have a small number of institutional investors, and (ii) where such investors unanimously resolve for the new LMT regime not to apply until the end of a deferral period. In such circumstances, managers could be required to update their documentation for such funds only following a defined period commencing on the earlier or (i) a new investor subscribing for fund interests, or (ii) an existing investor transferring its interests. This should avoid unnecessary administration for existing customised vehicles where existing investors were heavily involved in the vehicle's original establishment.

Conclusion

We hope these comments, along with the responses to the specific questions in the consultations, will constructively contribute to ESMA's consideration of these important issues.