FINANCIAL CONDUCT AUTHORITY

Consultation Paper
CP25/38**

Enhancing fund liquidity risk management

December 2025

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Contents

Contents by sector

This table sets out which chapters are particularly relevant for each sector. This is where you will find the most relevant chapter(s) for your firm.

Sector	Chapter
Authorised fund managers (AFMs) of UCITS schemes and non-UCITS retail schemes (NURS)	3, 4, 5
Alternative investment fund managers (AIFMs)	6

Chapter 1

Summary

Why we are consulting

1.1 Effective liquidity risk management, particularly for open-ended funds (those that create and redeem units under the terms offered to investors), is vital to safeguard investors' interests. It also supports orderly markets by reducing the likelihood of disorderly selling of assets that might impact other funds with similar strategies or, in extreme cases, threaten financial stability.

1.2 In May 2025, the International Organization for Securities Commissions (IOSCO) published its revised recommendations for liquidity risk management for collective investment schemes ('funds'). These set new international standards for fund liquidity risk management. We actively helped develop these recommendations, which took account of the Financial Stability Board's (FSB) own revised recommendations to address structural vulnerabilities from liquidity mismatch in open-ended funds.

1.3 The FCA Handbook already sets out a robust liquidity risk management framework and minimum standards for the investments that can be held in an authorised fund. It also requires authorised fund managers (AFMs) to maintain a prudent spread of risk and ensure a fund's liquidity matches its redemption terms. These rules protect consumers and have been reinforced through 'Dear CEO' letters, multi-firm reviews and enforcement action where needed. We recognise that many AFMs have already taken note and sought to improve their internal systems and liquidity risk management practices.

1.4 We do not believe that fundamental changes are needed to the existing framework for authorised funds and have observed some good practices. However, we think that more can still be done to improve liquidity risk management, to reflect the fundamental role it plays in the management of open-ended funds.

1.5 We have therefore identified specific areas where we can enhance our rules and provide additional guidance.

1.6 We would expect AFMs to carefully consider whether the redemption terms of the funds they manage are in practice aligned with their liquidity profile, particularly where they have large exposures to less liquid transferable securities.

1.7 AFMs should not work on the assumption that daily-dealing is always the best structure. We want firms to choose fund structures that appropriately match the liquidity of the underlying assets, which is consistent with the IOSCO recommendations. For this reason, we have introduced the Long-term asset fund (LTAF) which allows for investment into longer-term assets within an authorised fund structure and has redemption terms to match the illiquidity of the portfolio. However, we also recognise that the fund distribution system has been largely built around a daily-dealt model and that there are challenges associated with moving away from that.

1.8 Where funds do offer daily dealing, AFMs must ensure that they take sufficient measures to manage the portfolio's liquidity and our proposals aim to help these AFMs deliver improved liquidity risk management. This includes (1) having liquidity management tools available and using them effectively, and (2) interrogating and adequately accounting for the liquidity risks of the assets in the portfolio through a robust liquidity risk management system.

What we want to change

1.9 At a high level, the proposed new rules and guidance in this consultation paper (CP) are targeted at AFMs of UCITS schemes and non-UCITS retail schemes (NURS). Both of these are authorised funds aimed at retail investors.

1.10 We also propose to create two new guidance annexes in the Collective Investment Schemes Sourcebook (COLL) which will incorporate key aspects of the IOSCO recommendations and the expectations we have communicated to date on liquidity risk management.

1.11 The first annex would provide guidance on effective liquidity risk management systems, including when dealing with non-redemption pressures, and the second is an updated version of the existing European Securities and Markets Authority (ESMA) liquidity stress testing guidelines. We propose that these annexes apply to AFMs of UCITS schemes and NURS, however we will consider the application to other alternative investment funds (AIFs) when developing our proposals for the separate CP on reform of the Alternative Investment Fund Managers Directive (AIFMD) regime, scheduled for 2026.

1.12 Our proposals should not require AFMs to make significant changes in how they approach liquidity risk management and we propose retaining the principle that an AFM is ultimately responsible for the management of a fund in the best interests of its investors. However, from previous market studies and supervisory engagement, we have seen cases where AFMs could improve their liquidity risk management practices in certain areas. While we believe that, under the existing rules, AFMs should already regularly review their practices to determine where improvements can be made, the proposals in this CP should underscore the importance of the AFM's ongoing responsibility for liquidity risk management and provide clarity on what our expectations are.

1.13 We also recognise the importance of supporting capital markets by enabling authorised funds to invest in a wide range of assets, including small-cap securities. We have had some feedback that some firms have taken previous communications to be an instruction to not invest in assets which could be more likely to have limited liquidity, for example small and micro-cap equities. This is not the case, but our rules do require AFMs to take a holistic view of liquidity within a fund, and the size of investments relative to available liquidity. We have designed our proposals to align with this aim and welcome stakeholder views on whether they achieve that outcome.

1.14 In summary, we want to cement existing good practice by proposing targeted changes to the current framework for fund liquidity risk management. Our proposals aim to:

a. **Promote effective use of anti-dilution tools (such as swing pricing) by AFMs of UCITS schemes and NURS.** This would help prevent the value of investors' investments being diluted over time due to bearing the costs of other investors entering and exiting the fund. We explain these proposals in Chapter 3.
b. **Ensure that AFMs of UCITS schemes and NURS have robust liquidity risk management processes,** especially where they have exposure to less liquid assets. We explain these proposals in Chapter 4.

1.15 Chapter 5 explains what we expect when an AFM has delegated the portfolio management to a MiFID investment manager. However, we are not proposing new rules for MiFID investment managers at this point.

1.16 Liquidity risk management is also relevant to AIFs other than NURS. In Chapter 6, we signpost proposed changes to the baseline liquidity framework in AIFMD, which will be set out in the 2026 CP. In that CP, we will also consult on revised proposals to address the liquidity mismatch in some authorised AIFs invested in inherently illiquid assets, such as authorised property funds. If we proceed with mandatory notice periods, we will give affected firms a reasonable transition period to make the necessary operational changes.

Scope

1.17 The proposals in this paper apply to:

- AFMs for their UCITS schemes and NURS. One of the proposed changes, to the definition of 'dilution', has relevance for LTAFs and qualified investor schemes (QIS). However, this should not have a material impact on an LTAF or a QIS.
- MiFID investment managers, where the AFM has delegated the portfolio management function of a UCITS scheme or NURS to them.
- Depositaries of authorised funds.
- Investment platforms and other fund distributors.

1.18 This paper may also be of interest to:

- Investors in authorised funds.
- Financial advisers and investment consultants.
- Alternative investment fund managers (AIFMs) managing authorised and unauthorised AIFs, covered in Chapter 6 (Looking ahead to the 2026 AIFMD review consultation).

1.19 Exchange-traded funds (ETFs) and money market funds (MMFs) were not in scope of IOSCO's recommendations.

1.20 Our substantive proposals on anti-dilution tools do not apply to MMFs, as CP23/28 proposed an updated regime for MMFs, which included rules on how managers of such funds should account for dilution risk. However, as explained in Chapters 3 and 4, some of the smaller changes we propose would apply to an MMF in its capacity as a UCITS scheme or NURS, given the structure and application of COLL. Although our proposals are not specifically targeted at ETFs, they would apply to any UK ETF that it is a UCITS scheme or a NURS.

Next steps

1.21 Please respond to the questions in this CP by Monday 23 February using our electronic survey or one of the other methods in the 'How to respond' section.

Chapter 2

The wider context

Previous work on liquidity risk management

2.1 In December 2019, the Bank of England's Financial Policy Committee (FPC) judged the mismatch between redemption terms and the liquidity of some funds' assets could potentially result in systemic risk. The FPC recommended greater consistency between the liquidity of a fund's assets and its redemption terms. Specifically:

- Liquidity of funds' assets should be assessed either as the price discount needed for a quick sale of a representative sample of those assets or the time needed for a sale to avoid a material price discount.
- Redeeming investors should receive a price for their units that reflects the discount needed to sell the required portion of a fund's assets in the specified redemption notice period.
- Redemption notice periods should reflect the time needed to sell the required portion of a fund's assets without discounts other than those captured in the price received by redeeming investors.

2.2 In recent years we have focused on good liquidity risk management practices when supervising fund managers and their delegates, and we have also made or proposed changes to our Handbook.

2.3 Those changes include new rules for funds holding illiquid assets (PS19/24: Illiquid assets and open-ended funds) and a consultation on proposals to address liquidity mismatch in authorised property funds (CP20/15: Liquidity mismatch in authorised open-ended property funds). In 2019, we issued a 'Dear CEO' letter on Effective liquidity management: good practice for Authorised Fund Managers. In 2023, we issued a further letter following the completion of our multi-firm review. This multi-firm review informed our discussions with IOSCO on the development of its revised recommendations.

2.4 Our new proposals align with the FPC's recommendations by ensuring that AFMs have anti-dilution tools available for use. Our proposals also include guidance that, when calibrating these tools, the AFM should consider the explicit and implicit liquidity costs associated with selling a pro-rata apportionment of the scheme property (a vertical-slicing approach). Our AIFMD review CP next year will include proposals to ensure that AIFMs of illiquid AIFs have redemption terms which reflect the portfolio's illiquidity, as part of a more general review of the AIFMD liquidity framework.

The impact on consumers

2.5 Our proposals aim to strengthen AFMs' liquidity risk management frameworks in the interests of consumers. However, an AFM should already be paying close attention to the fund's proposed liquidity profile and redemption terms when deciding how it will meet its target consumers' needs. Under the Consumer Duty ('the Duty'), firms should also put consumers at the heart of their business and focus on delivering good outcomes.

2.6 According to the Investment Association (IA), the net asset value of UK authorised funds (funds regulated by the FCA, including retail products) in September 2025 was £1.58 trillion, growing from £1.49 trillion in September 2024. This reflects high levels of confidence in UK fund managers, and UK funds have generally shown good resilience to various stress events, such as the pandemic and the Russian invasion of Ukraine.

2.7 Fund managers are permitted to suspend dealings in exceptional circumstances and if it is in the best interests of unitholders. Although very few funds have suspended for liquidity reasons, poor liquidity management can cause significant harm to retail investors and damage trust in the UK's fund management sector. An example was the mismanagement of the Woodford Equity Income Fund (WEIF), which saw thousands of investors unable to recover their investment in full. In this case, we found all parties had failed to act with due skill, care and diligence.

2.8 Woodford Investment Management (WIM) and Mr Neil Woodford have referred their Decision Notices to the Upper Tribunal. References in this CP to matters relating to the WEIF refer, insofar as they concern WIM and Mr Woodford, to the provisional findings of the FCA in our Decision Notices and are subject to the Upper Tribunal's determination in due course.

2.9 In recent years, there have also been multiple suspensions of daily-dealt authorised property funds for valuation and liquidity reasons. This has meant that investors are unable to access their money invested in those funds for considerable periods of time, despite those funds operating on a daily-dealt basis. These delays in investors being able to access their investments can also deepen investor losses. This underscores the importance of an AFM ensuring that a fund's liquidity profile is in fact consistent with its redemption terms, both at the design stage and on an ongoing basis, including under different market conditions.

2.10 We consider the existing Handbook rules to be sufficiently robust to protect investors and our approach to reinforcing strong liquidity management practices also involves taking action against non-compliance. However, by enhancing our existing rules and guidance, our proposals aim to provide for the fair treatment of all investors, by ensuring that AFMs treat subscribing, remaining and redeeming investors equally.

Background to the IOSCO recommendations

2.11 In 2018, IOSCO made recommendations for liquidity risk management for collective investment schemes. IOSCO's thematic review in 2022 found the UK was compliant with the key principles of its 2018 recommendations.

2.12 In 2023, the FSB published its revised policy recommendations to address structural vulnerabilities from liquidity mismatch in open-ended funds.

2.13 IOSCO has since revised its recommendations in response to the FSB's recommendations and made targeted changes to:

a. **Incorporate the FSB's proposed categorisation of open-ended funds.** This is rooted in the principle that a fund's liquidity profile should be consistent with its redemption terms, both at the time the fund is designed and on an ongoing basis. The FSB and IOSCO recommend that funds which invest mainly in 'less liquid' assets and provide daily liquidity without notice / settlement periods should have anti-dilution tools ready to tackle investor dilution. The FSB and IOSCO recommend that funds invested in illiquid assets should create and redeem shares less frequently than daily and/or have longer notice or settlement periods.
b. **Emphasise that fund managers should consider and implement a broad set of liquidity management tools.** They should do this in both normal and stressed market conditions, as part of robust liquidity management practices.
c. **Specify that fund managers should consider and use anti-dilution tools** to reduce material investor dilution and potential first-mover advantage from structural liquidity mismatch. They should do this by allocating the explicit and implicit costs to both subscribing and redeeming investors. These costs should include any significant market impact of asset sales to meet their redemptions.
d. **Provide guidance on using and calibrating liquidity management tools.**

2.14 We are comfortable that AFMs already have access to a range of liquidity management tools. However, requiring AFMs of UCITS schemes and NURS to have anti-dilution tools will align with IOSCO's recommendation for funds invested in less liquid assets. Currently, the liquidity profile of a UCITS scheme or an AIF must be consistent with its redemption terms. However, we know of a few cases of liquidity mismatch in AIFs invested in inherently illiquid assets (such as daily-dealt property funds) which, as mentioned above, we intend to address through the 2026 AIFMD reform CP.

Wider context

2.15 In December 2024 the FSB published its recommendations on liquidity preparedness for margin and collateral calls. The relevance of these separate recommendations is wider than just fund managers. They advise all market participants to incorporate the assessment of liquidity risks from derivative and securities finance exposure into their liquidity risk management and governance frameworks. They also advise identifying and accounting for potential liquidity strains caused by margin and collateral calls.

2.16 Consideration of non-redemption pressures is a key component of an effective liquidity risk management system. The FSB recommendations on margin and collateral complement the IOSCO liquidity risk management recommendations. So, we have taken them into account in developing the proposals in this CP.

2.17 However, our existing regime for UCITS schemes is broadly consistent with the FSB recommendations on margin and collateral, as it already sets limits and controls on leverage and derivative exposure.

2.18 When developing our proposals for the 2026 AIFMD review CP, we will also take the FSB margin and collateral recommendations into account, in addition to the FSB's recommendations to address financial stability risks created by leverage in non-bank financial intermediation, published in July 2025.

Outcome we are seeking

2.19 Our anti-dilution proposals for UCITS schemes and NURS will help AFMs set prices more accurately, protecting remaining investors from dilution and discouraging some investors from seeking to take advantage of liquidity mismatch. This reduces the risk of 'fire sales' and market contagion. Our proposals to strengthen the liquidity risk management framework for UCITS schemes and NURS should mean all AFMs consider whether their existing risk management procedures are sufficient.

Anti-dilution tools

2.20 The purpose of anti-dilution tools is to adjust the price paid / received by incoming / exiting investors. This should protect remaining investors from a dilution of value from the cost of buying / selling the underlying investments to meet these dealing requests.

2.21 We expect our anti-dilution proposals for UCITS schemes and NURS will mean AFMs better calibrate their price adjustment where there is a risk of material dilution. This should mean both incoming and exiting investors pay or receive a more accurate price for their units, while better protecting the remaining investors from dilution effects. In turn, it should reduce the incentive for some investors to redeem before others ('first mover advantage') which harms investors who cannot act quickly.

2.22 That is because, where these tools are used ineffectively or not at all, the AFM may be inclined to meet redemption requests by relying on the most liquid assets in the portfolio, rather than selling a pro-rata apportionment of the scheme property ('vertical slicing'). The rationale is that the most liquid assets can more likely be sold quickly with a smaller price discount. However, while this practice could limit the immediate dilution effect for remaining investors, it exposes them to an increasingly illiquid portfolio.

2.23 Once the liquid assets are exhausted, the AFM may then need to 'fire sell' the less liquid assets, which risks contagion to funds with similar exposures and also means that investors who redeem later receive a lower price for their units.

2.24 More effective use of anti-dilution tools should therefore help reduce the need for such fire sales to take place by helping the AFM to maintain the liquidity profile of the fund when meeting redemption requests, and therefore reducing the incentive for some investors to exit the fund ahead of others.

2.25 In addition to redemption pressures, anti-dilution tools can also be used to account for the risks of 'surge' investing, by adjusting the price paid by subscribing investors and so protecting investors already in the fund. For example, in a scenario in which a large number of investors subscribe to a fund, particularly one that invests in assets with relatively low volume, there is a risk that the AFM artificially increases the price of those assets by increasing the size of the portfolio. This can lead to heightened volatility and subsequent losses.

UCITS schemes and NURS liquidity risk management

2.26 We do not expect our proposals for UCITS schemes and NURS to cause any AFMs to adjust their funds' portfolios, at least in the immediate term. The proposals should not be considered a fundamental change in how AFMs assess assets' eligibility. However, AFMs managing funds with significant holdings of less liquid assets, such as small companies funds, or assets with reasonable liquidity but in which the fund is a very large investor relative to that liquidity, will need to carefully consider whether their existing risk management procedures sufficiently account for the liquidity risks of the portfolio.

2.27 Good liquidity management practices can also strengthen the resilience of open-ended funds to any future market shocks. They can ensure AFMs have a good understanding of where a potential liquidity shortage or liquidity pressures might arise, and how the investors might react under different scenarios.

Measuring success

2.28 We are reviewing fund reporting to improve the data we collect on funds' portfolios and risks, their investor base and how they use anti-dilution tools. This data will allow us to build a more accurate picture of funds' liquidity positions, while making reporting obligations proportionate to the benefits of this data. We will consult separately on changes to fund reporting in due course.

2.29 In the interim, we will monitor how effectively firms implement our amended rules and guidance on anti-dilution tools. We may carry out supervisory spot checks and outlier analysis, monitoring at the authorisations gateway, or a future survey or multi-firm review.

2.30 Given that each fund's circumstances will be unique, we will continue to take a risk-based approach to supervising the liquidity risk management of UCITS schemes and NURS. We consider that effective implementation of the proposed changes to how the AFMs of UCITS schemes and NURS manage their funds' liquidity should not lead to any immediate changes which are noticed by investors. However, in the longer term the proposed changes should improve the resilience of these funds to any future market stress events, and therefore reduce the risk of any investor harm caused by poor liquidity risk management.

The harm we are trying to reduce/prevent

2.31 Poor liquidity risk management by an AFM can significantly harm investors and undermine confidence in the UK's fund management sector.

Anti-dilution tools

2.32 There are risks when AFMs of UCITS schemes and NURS lack, or ineffectively use, anti-dilution tools. These tools – such as dual-pricing, dilution levies, or swing pricing – are designed to protect remaining investors from the costs of others entering or exiting the fund. Without proper use or calibration, remaining investors may unfairly bear transaction costs, face increased portfolio illiquidity, or be disadvantaged by 'first mover advantage' when liquid assets are depleted.

UCITS schemes and NURS liquidity risk management

2.33 If a UCITS scheme or NURS invests in less liquid securities, or hold investments of a size that is challenging for available liquidity, the AFM must ensure redemption terms match portfolio liquidity and maintain strong liquidity risk management. Without this consistency, funds are more exposed to stress events, whether fund-specific or market-wide. Investors, especially retail, may not realise the risk of the AFM being unable to sell less liquid assets quickly to meet redemption requests.

How our proposals meet our objectives

2.34 These proposals are compatible with our strategic objective, of ensuring that relevant markets function well.

2.35 These proposals also advance our operational objectives. They are intended to ensure that AFMs manage their funds so investors can redeem as expected and are treated fairly, ensuring consumer protection.

2.36 Further, enhancing the liquidity risk management practices of UCITS schemes and NURS should also strengthen UK market resilience and market integrity, especially in less liquid sectors. By keeping AFMs responsible for their funds' liquidity management, we should enable them to make suitable decisions for their funds and to pursue innovative opportunities, such as investing in small high-growth companies, which should promote effective competition in the interests of consumers.

2.37 By following IOSCO recommendations without adding extra requirements, we support growth and the international competitiveness of the UK economy, maintain regulatory predictability, and keep costs low for firms and investors.

Wider effects of this consultation

2.38 Our proposals support UK capital markets by enabling responsible investment in new and smaller companies, as long as the AFM manages any associated liquidity risks.

2.39 In recent years we have also delivered multiple initiatives to support innovation in UK capital markets. These include the Listing Rules reform, the Digital Securities Sandbox (DSS) and the PISCES sandbox. In July 2025 we also published a Discussion Paper (CP25/20) seeking views on whether current equity transparency rules provide an adequate picture of UK equity liquidity.

Environmental, social & governance considerations

2.40 In developing the proposals in this CP, we have considered the environmental, social and governance (ESG) implications of our proposals and our duty under ss. 1B(5) and 3B(1)(c) of the Financial Services and Markets Act 2000 (FSMA) to have regard to contributing towards the Secretary of State achieving compliance with the net-zero emissions target under section 1 of the Climate Change Act 2008 and environmental targets under s. 5 of the Environment Act 2021.

2.41 On balance, we do not think that there is any contribution the proposals outlined in this CP can make to these targets. We will keep this issue under review during the consultation period and when considering whether to make the final rules.

Question 1: **Do you have any comments on the ESG implications of our proposals?**

Equality and diversity considerations

2.42 Overall, we do not consider our proposals materially impact any of the groups with protected characteristics under the Equality Act 2010 (in Northern Ireland, the Equality Act is not enacted but other anti-discrimination legislation applies). We will keep this position under review as we review feedback to the CP and develop our final rules and guidance.

Question 2: **Do you have any comments on the equality and diversity implications of our proposals?**

Chapter 3

Promoting effective use of anti-dilution tools

Introduction

3.1 An authorised fund must either be dual-priced or single-priced. While dual-pricing should act as an anti-dilution tool in itself, under COLL 6.3.8R the AFM of a single-priced fund may:

a. require subscribing or redeeming investors to pay a dilution levy (commonly referred to as a 'liquidity fee');
b. make a dilution adjustment to the price paid by subscribing or redeeming investors (commonly referred to as 'swing pricing'); or
c. neither of these.

3.2 Under COLL 4.2.5R (18), the AFM must disclose its dilution policy in the prospectus. An AFM of a single-priced fund therefore cannot choose to use either of these tools unless it has already given itself the ability to do so by making the necessary disclosures in the prospectus.

3.3 All funds incur both explicit and implicit costs from buying and selling the portfolio's underlying assets to meet subscription and redemption requests. So we see no reason why an AFM of a single-priced fund should not have the ability to use an anti-dilution tool, even if the risk of material dilution in its fund is usually minimal. We therefore propose to require AFMs to have at least one of these tools available, so that all authorised funds are either dual-priced or, if single-priced, their AFM can require a dilution levy or make a dilution adjustment.

Current market picture

3.4 In 2020 we carried out a joint survey with the Bank of England on liquidity management in UK open-ended funds, focussing on the use and calibration of anti-dilution tools. 51 AFMs responded (around half the current number of active AFMs) on behalf of 272 funds. Four AFMs managed at least one fund without any anti-dilution tools available.

3.5 We do not have reporting data on the availability or use of anti-dilution tools so we have chosen to use the data from the 2020 survey which is the most detailed data set available. However, we do not expect that market practice has significantly changed since then, with the 2023 multi-firm review finding similar practices, albeit with a much smaller sample size.

3.6 The survey found that funds with different primary strategies and assets, but managed by the same fund manager, generally used both the same thresholds for applying swing pricing and the same calculation of the standardised swing factor. This suggests fund managers may not be fully considering specific factors such as the investor base or the asset mix for individual funds, when using anti-dilution tools.

3.7 The survey also found many AFMs did not explicitly consider market impact. Only 13 of the 272 funds that were surveyed included it in their swing factors. Our 2023 multi-firm review also found a variety of approaches in the use of swing pricing. For example, thresholds for volumes of redemption orders to trigger the use of swing pricing in fund ranges were often the same across all funds, notwithstanding their different underlying asset classes.

3.8 So AFMs could improve their use of anti-dilution tools in several areas.

Options we have considered

3.9 We have considered various options to address the identified areas for improvement in current market practices, and propose to require AFMs of UCITS schemes and NURS to have anti-dilution tools available and policies to identify dilution, assess its impact on unitholders, and determine when to activate and how to calibrate the tools, subject to appropriate governance.

3.10 This would mean AFMs remain ultimately responsible for deciding when to activate and how to calibrate these tools, but must use them to protect unitholders from the risk of dilution. We would expect the use of these tools to vary, and to be tailored to the funds' individual circumstances.

3.11 We consider this approach best aligns with our objectives of protecting consumers and the integrity of the UK's financial system, while also promoting effective competition in consumers' best interests.

3.12 Our decision is based on the principle that an AFM should remain ultimately responsible for the management of the fund, and that choosing and applying these tools should be tailored to the fund's specific circumstances, which makes taking a more prescriptive approach undesirable.

3.13 By not going beyond IOSCO's recommendations, we are also furthering our secondary objective for growth and international competitiveness, as taking a more prescriptive approach could reduce the attractiveness of the UK asset management sector.

3.14 We recognise this option continues to allow variation in how AFMs apply and calibrate their anti-dilution tools. We do not believe it is desirable to standardise the calibration of these tools across all funds. However, we propose to require an AFM to review at least annually its dilution policy's effectiveness in ensuring fair treatment of investors in each fund. This should help ensure that AFMs are making good use of their ability to tailor the calibration of these tools to their funds' unique circumstances.

3.15 We considered other options to achieve our desired outcomes. They include:

a. **Requiring AFMs of UCITS schemes and NURS to have anti-dilution tools available and setting out in rules when they should be activated (such as redemptions or subscriptions as a percentage of Net Asset Value (NAV)) and how they should be calibrated (such as the factors the AFM must take into account).**
We chose not to proceed with this option because although rules that standardise practices for activating anti-dilution tools would give investors clarity on their use, fixed thresholds may not suit all funds and could allow some investors to predict and exploit their use.
b. **Introducing no new rules, but providing guidance on the internal governance which should decide the use of anti-dilution tools and which calibration factors to consider.**
We chose not to proceed with this option because, although the benefits would be broadly the same as our chosen approach, it would not close the gap for the small minority of AFMs which do not have these tools available.

3.16 We propose not to apply the amended anti-dilution rules to an LTAF, a QIS or an MMF. In the case of MMFs, CP23/28 proposed alternative dilution rules for MMFs which would sit in the new *MMFS* sourcebook. We will confirm the position for MMFs in due course. We will consider the position for LTAFs and QIS in the separate AIFMD review CP in 2026.

3.17 However, while we have excluded an LTAF, QIS and MMF from the scope of our substantive proposals, some of the smaller proposed changes, such as to the definition of 'dilution' in the Handbook, would apply, as set out in the table on page 23.

Our proposal

3.18 To implement this option, we propose making the following changes. These changes and their application are summarised in the table at the end of the chapter.

Definition of 'dilution'

3.19 The glossary definition of 'dilution' refers to the amount of dealing costs incurred, or expected to be incurred, by or for the account of a single-priced authorised fund. As dilution can occur in a dual-priced fund, although the tool used to mitigate it is different, we propose to amend the definition so that it refers instead to an 'authorised fund'.

3.20 The definition already explains that 'dealing' costs include both the costs of dealing in an investment and, where there is a spread between the investment's buying and selling prices, the indirect cost that results from the differences between those prices. This respects the key principle of the IOSCO recommendations that the calibration of anti-dilution tools should reflect both the explicit and implicit costs of transacting in the underlying instruments, and so we do not propose to make any further changes to the definition.

Availability of anti-dilution tools

3.21 Although most AFMs of UCITS schemes and NURS already have anti-dilution tools available for use and should have policies and procedures in place for how and when they are used to ensure all investors are treated fairly, we propose to require AFMs explicitly to put policies and procedures in place which set out:

- **a.** how the AFM will identify actual or potential instances of dilution affecting the value of the scheme property
- **b.** how, where the AFM has identified an instance of dilution, it will assess the actual or likely impact on the unitholders at each valuation point
- **c.** which anti-dilution tool the AFM will use to protect unitholders' interests

3.22 Under the proposed rules, an AFM must then apply its policies and procedures as appropriate and in a timely way to protect the interests of unitholders. However, the AFM would retain its discretion to determine when a dilution risk is sufficiently material to warrant the activation of its anti-dilution tools.

3.23 We propose that anti-dilution tools available to an AFM should remain unchanged – either dual-pricing or, in a single-priced fund, a dilution levy or a dilution adjustment. The new requirement would therefore apply to an AFM of a dual-priced fund. The impact on dual-priced funds is discussed in further detail below.

3.24 Some stakeholders would like us to modify our rules to allow AFMs more flexibility to close an authorised fund to further subscriptions, while continuing to carry out redemption requests. This is commonly referred to as 'soft closure'. It may be useful where inflows of investor money exceed opportunities to buy underlying assets in line with the fund's investment aims, which can lead to the fund holding excess amounts of cash. That makes it more difficult for the AFM to pass on the correct costs of underlying market transactions to the investors buying and selling units.

3.25 Our rules allow AFMs to introduce this mechanism as a significant change to the fund requiring adequate written notice to unitholders, but some AFMs have told us they need to be able to activate the mechanism at short notice for it to be effective. We are concerned that if AFMs could make such a major change without giving sufficient notice, it could be harmful to investors' interests. However, in the context of managing the effects of dilution, we accept that a balance may have to be struck between some investors' information needs and the AFM's ability to take timely action in the interests of the fund as a whole. Therefore, we are open to considering this matter further.

Question 3: **Do you agree that we should require all AFMs of UCITS schemes and NURS to have anti-dilution tools available for use, if they do not already do so?**

Question 4: **Do you agree that the three anti-dilution tools available to an AFM should be dual-pricing, a dilution adjustment or a dilution levy? If not, what other tools do you think should be available and why?**

Question 5: **As a possible alternative, do you believe that having the ability to close a fund to new investors only ('soft close') would enhance the fund's ability to avoid dilution?**

Question 6: **Do you agree that the position for LTAFs and QIS should be considered separately as part of the 2026 AIFMD review CP?**

Calibrating anti-dilution tools

3.26 Although the AFM must use its anti-dilution tools to protect its unitholders from the effect of dilution, we propose guidance to make clear the AFM need not apply the mechanism when it has reasonably assessed that the actual or potential dilution does not pose a material risk to unitholders. For example, cash outflows due to the redemption of units may be offset against cash inflows from the purchase of units.

3.27 We also consider that for anti-dilution tools to work effectively, they should be calibrated to reflect both the explicit and implicit costs of transacting in the underlying assets. In our response to the 2023 multi-firm review we already explained that we consider incorporating market impact cost into the methodology for calculating the swing factor is good practice.

3.28 So, the proposed guidance explains that the AFM's policies and procedures should provide for the appropriate calibration of its anti-dilution tool(s), and take into account:

a. The explicit and implicit liquidity costs of an actual or potential transaction, calculated on the basis of a pro-rata apportionment of the scheme property across all unitholders ('vertical slicing'). This requires the AFM to assume that it meets a redemption request by selling a vertical slice of the portfolio, rather than relying on its most liquid assets, thus maintaining the fund's liquidity profile.

b. An appropriate estimate of the likely impact on the price of a transferable security where the AFM is required to sell a significant quantity of that security to meet redemption requests (the expected market impact). This can be done by reference to previous transactions or relevant market data and models.

3.29 The proposed new COLL 6 Annex 4, which is explained in paragraph 4.42 and sets out guidance on good liquidity risk management practices, is also relevant to an AFM in terms of the governance it applies to using anti-dilution tools.

Question 7: **Do you agree with the factors included in the proposed guidance regarding calibration of anti-dilution tools, for example that an AFM should take into account both explicit and implicit costs when calibrating its anti-dilution tools?**

Review mechanism

3.30 In response to the 2023 multi-firm review, we said that 'back testing' to enhance and demonstrate swing pricing effectiveness is good practice. Back testing is the practice of assessing the prices achieved for assets that have been sold against the value prior to sale, to verify market impact of the sale and assess how all unitholders have been treated fairly when assigning costs between subscribing, remaining and redeeming investors. It can also be applied to asset purchases.

3.31 To support the effective calibration of its anti-dilution tools, we therefore propose to require an AFM of a UCITS scheme and NURS to assess retrospectively for each fund how decisions to apply its anti-dilution mechanism to the sales and redemptions of units ensured that all unitholders were treated fairly. The AFM would need to conduct this assessment at least annually. However, we expect most AFMs would already carry out a similar assessment to determine the effectiveness of unit pricing controls and their existing dilution policies.

3.32 This corresponds to the existing requirement that applies for an LTAF under COLL 15.7.21R (4).

3.33 We do not propose to prescribe how an AFM should carry out this assessment. However, the proposed guidance to accompany the new requirement explains that the AFM should consider:

- **a.** the choice of mechanism it used
- **b.** the calibration of the mechanism
- **c.** whether the frequency at which it applied the mechanism was appropriate, taking account of the particular characteristics of the scheme property and the information available to the AFM about the scheme's investor profile

Question 8: **Do you agree that the AFM of a UCITS scheme and a NURS should be required to annually review the effectiveness of its anti-dilution policies to ensure all unitholders have been treated fairly?**

Contents of the prospectus

3.34 As the selection of anti-dilution tools would no longer be optional for an AFM of a UCITS scheme and NURS, we propose to amend the requirement to disclose the choice of these tools in the prospectus.

3.35 Under COLL 4.2.5R (18) an AFM of a single-priced fund must currently include a statement in the prospectus explaining which anti-dilution tool it has chosen to use (a dilution levy or a dilution adjustment). It must explain how this policy may affect the authorised fund's future growth. The AFM must also disclose other information, such as its policy in deciding when to require a dilution levy or dilution adjustment, and the estimated rate based either on historical data or future projections.

3.36 We propose to require AFMs to set out in the prospectus the policies and procedures required under COLL 6.3.7AR (in short, the points listed in (a)-(c) in paragraph 3.21), whether the fund is dual-priced or single-priced. Where the fund is single-priced, the policies and procedures must include the matters set out in COLL 6.3.7AR (3), corresponding to the matters which must be currently disclosed in the prospectus under COLL 4.2.5R 18(b) (i.e. disclosure of the estimated rate or amount of any dilution levy or dilution adjustment),

3.37 An AFM may therefore need to update the prospectus to provide further detail on its policies and procedures, if it considers that its existing disclosures are not sufficient. The position for dual-priced funds is discussed below.

Fair treatment of unitholders

3.38 AFMs should set the price of units in a way that ensures fair treatment between unitholders who are dealing in units and unitholders who were already invested or remain invested in the scheme. As a dilution risk can be present in both a dual-priced fund and a single-priced fund, we propose to add guidance provisions (COLL 6.3.5BAG and 6.3.8AG) to state that an AFM should apply the appropriate anti-dilution tools for each type of pricing mechanism to achieve this outcome.

Dual-priced funds

3.39 Although under our proposals the concept of dilution in COLL would apply to a dual-priced fund for the first time, we consider that dilution risk exists equally in a single-priced and a dual-priced fund, only that the tools to address this risk are different. By making it explicit that the AFM's responsibility to prevent dilution also applies for a dual-priced fund, the AFM would also be brought into scope of associated requirements. These being:

a. **Prospectus disclosure:** The AFM of a dual-priced fund would need to disclose its anti-dilution policies and procedures under the amended COLL 4.2.5R (18). Under COLL 4.2.5R 16(b)(v), the AFM is already required to disclose an explanation of what is meant by large deals and the AFM's policy in relation to such deals. We consider this to be the existing equivalent of COLL 4.2.5R (18) for a single-priced fund. The AFM of a dual-priced fund will therefore need to consider whether its existing explanation of its dual-pricing mechanism is sufficient to comply with the amended rule.
b. **Record keeping:** Under COLL 6.6.6R (3), an AFM must make and retain for a period of six years a daily record of (i) how it calculates and estimates dilution and (ii) its policy and method for determining the amount of any dilution levy or dilution adjustment. As the definition of dilution will now also apply to a dual-priced fund, the first limb of COLL 6.6.6R (3) would apply.

   However, under COLL 6.6.6R (1) an AFM must already make and retain for six years such records as enable the scheme and the AFM to comply with the rules in COLL and the Open-Ended Investment Company (OEIC) Regulations; and to demonstrate that compliance has been achieved. We expect that an AFM of a dual-priced fund would therefore already keep a record of its dual-pricing calculation and the measures it has taken to provide for the fair treatment of all investors. We therefore do not consider that bringing the AFM of a dual-priced fund into scope of COLL 6.6.6R (3) would create any new substantial obligation for the AFM.

c. **Significant changes and informing unitholders:** Under COLL 4.3.6R an AFM must give prior written notice to unitholders in respect of any proposed change to the operation of a scheme that constitutes a significant change. COLL 4.3.7G explains that changes may be significant depending in each case on their degree of materiality and effect on the scheme and its unitholders, and so the AFM will need to determine whether in each case a particular change is significant in nature or not. However, this is likely to include a change in dilution policy.

   As is already the case for any AFM of a single-priced fund which is updating its dilution policy, an AFM of a dual-priced fund will need to consider whether any changes it makes to the way in which its dual-pricing mechanism is calibrated would constitute a significant change and inform investors accordingly.

Question 9: **Do you agree with our proposed approach for dual-priced funds? Do you anticipate there may be any other implications of our proposals beyond those explained above?**

Effect on other market participants

3.40 Some other market participants may be affected by our proposals. Investment platforms might need to make minor system updates to reflect the introduction of anti-dilution tools by a limited number of AFMs. However, we consider the impact should be small because platforms already accommodate the use of such tools for other AFMs and so should not need to put any new process in place.

3.41 Further, under COLL 6.6.4R a depositary must take reasonable care to ensure that the AFM considers whether to use the power provided by COLL 6.3.8R (Dilution) and, if so, the rate or amount of any dilution levy or dilution adjustment. However, the depositary has no duty in respect of the AFM using its discretion to activate these tools. We do not propose to place any new requirement on depositaries, although we expect they may need to make small changes to update their systems when an AFM introduces anti-dilution tools for the first time.

3.42 We have factored costs for investment platforms and depositaries into our Cost Benefit Analysis (CBA).

Question 10: **Do you have any other comments on our proposals relating to anti-dilution tools?**

Proposed change	Intended effect	Proposed application
Definition of 'dilution'	We propose to amend the definition so that it refers to an 'authorised fund', rather than a 'single-priced authorised fund', as dilution can occur in a dual-priced fund, although the tool used to mitigate it is different.	This definition would apply for all authorised funds, including an MMF, as CP23/28 proposed to use the existing definition of dilution for the new draft *MMFS* sourcebook.
Contents of the prospectus (COLL 4.2.5R (18))	We propose to amend the requirement to disclose the choice of these tools in the prospectus so that the AFM must explain the policies and procedures it has put in place under COLL 6.3.7AR.	The proposed amended rule would apply to UCITS schemes and NURS, except for MMFs where the existing requirements under COLL 4.2.5R (18), COLL 6.3.8R (1) and COLL 6.3.8R (1A) will continue to apply.
Purpose of chapter (COLL 6.3.2G 2(b))	We propose a small consequential change to explain that the chapter requires the AFM to take steps to mitigate dilution effects, rather than allowing it to do so.	This guidance would apply to all UCITS schemes and NURS, including those that are MMFs.
Sale and redemption price parameters for dual-priced authorised funds (COLL 6.3.5BAG)	As a dilution risk can also exist in a dual-priced fund, we propose to add a guidance provision which states that an AFM should apply the dual pricing rule to ensure fair treatment between unitholders who are dealing in units and those already invested or who remain invested in the scheme.	This guidance would apply to all dual-priced UCITS schemes and NURS that are not MMFs.
Dilution (availability) (COLL 6.3.7AR)	This proposed new rule would implement the requirement for an AFM to have anti-dilution tools available, and policies and procedures in place for using them.	This rule would apply to all UCITS schemes and NURS that are not MMFs.
Dilution (calibration) COLL 6.3.7BG - COLL 6.3.7DG	This proposed new guidance would set out the factors which AFMs should take into account when calibrating their anti-dilution tools.	This guidance would apply to UCITS schemes and NURS that are not MMFs.
Dilution (fair treatment of unitholders) (COLL 6.3.8AG)	This proposed new guidance provision would make clear that when an AFM is operating a dilution levy or dilution adjustment it should ensure fair treatment between unitholders who are dealing in units and those who were already invested or remain invested in the scheme.	This guidance would apply to all single-priced UCITS schemes and NURS, including those that are MMFs.
Dilution (annual review mechanism) (COLL 6.3.8BR and 6.3.8CG)	This proposed new rule and guidance would require an AFM to carry out an annual retrospective review of the effectiveness of its anti-dilution mechanism.	This rule and guidance would apply to all UCITS schemes and NURS that are not MMFs.

Chapter 4

UCITS schemes and NURS liquidity risk management

Introduction

4.1 UCITS schemes and NURS are aimed mainly at retail investors who expect to be able to redeem their investment on demand and be repaid promptly. Almost all UCITS schemes and NURS currently offer dealing on every business day. Effective liquidity risk management is therefore a core responsibility of the AFM. For most UCITS schemes and many NURS, transferable securities make up most of the scheme property. This makes the liquidity of those securities critical to a daily dealing model.

4.2 In implementing the IOSCO recommendations, we do not propose to introduce a prescriptive new liquidity classification framework. Instead, we propose to emphasise the AFM's responsibility for mitigating the liquidity risks of a fund's portfolio. That is because any security's liquidity can vary depending on market conditions, and many factors influence a fund's liquidity profile. These factors include portfolio diversification, the proportion of the security's issuance that the fund holds, investor concentration and profile and the AFM's liquidity management tools.

4.3 The current COLL rules do not prevent an AFM from investing in less liquid transferable securities, as long as their liquidity does not compromise the AFM's ability to redeem units. However, UCITS schemes and NURS with significant holdings in less liquid securities must properly manage the associated risks.

Options we have considered

4.4 We want to provide for strong liquidity management practices and a high level of consumer protection, while also allowing AFMs to continue to pursue their investment strategies through UCITS schemes and NURS. So, we propose:

- **a.** Removing the 'listed asset presumption' for transferable securities admitted to or dealt in on an eligible market.
- **b.** Removing the derogation from the eligible market test for recently issued securities which have not yet been admitted to an eligible market.
- **c.** Providing guidance on eligible market requirements.
- **d.** Requiring AFMs to consider conflicts of interests between investors wanting to exit the fund and those wanting to remain invested.
- **e.** Strengthening the rules for stress testing of UCITS schemes and bringing the ESMA liquidity stress test guidelines into the Handbook with some updates.
- **f.** Providing guidance on good liquidity risk management practices.

4.5 We considered other options to improve the liquidity risk management practices for UCITS schemes and NURS, but have chosen not to take them forward. They include:

- **Requiring AFMs to publish stress test results.** We do not believe this would provide a material benefit unless there were some form of standardising these results. It would be costly to implement and of limited use to retail investors.
- **Reducing the maximum proportion of assets that a UCITS scheme and a NURS can hold in their unapproved securities buckets (currently 10% of the value of scheme property for a UCITS scheme and 20% for a NURS).** We do not consider that doing so would materially improve AFMs' liquidity risk management processes. It could force AFMs to sell significant amounts of existing holdings, potentially on disadvantageous terms, to bring fund portfolios in line with the revised limits.
- **Prohibiting UCITS schemes or NURS from investing in less liquid transferable securities, or setting a limit on the proportion of less liquid transferable securities which can be held in the portfolio.** Prohibiting or limiting a UCITS scheme or NURS from holding less liquid transferable securities could significantly affect a large number of AFMs, such as those which manage small companies funds or corporate bond funds. For example, proposing prescriptive rules on the types of transferable security in which a UCITS scheme or NURS could invest might require many AFMs to significantly rebalance fund portfolios, alter fund investment objectives and policies, or withdraw their funds from the UK market. This policy could have a negative impact on UK markets and consumer outcomes.
- **Requiring less liquid transferable securities (which are admitted to an eligible market) to be held within the unapproved securities buckets and counted against the same maximum.** We consider it possible to mitigate the risks of holding such securities through an appropriate liquidity risk management process. The liquidity of all transferable securities will vary depending on market conditions, so we believe the AFM should ultimately decide whether a security's liquidity makes it appropriate for a fund or could risk compromising its ability to redeem units.

Our proposal

4.6 We propose making the following changes, which are summarised in the table at the end of this chapter.

Removing the 'listed asset presumption'

4.7 COLL 5.2.7AR sets out the criteria which a transferable security must fulfil to be eligible for investment by a UCITS scheme. COLL 5.6.5AR applies this requirement to a NURS. One of these criteria is that the liquidity of the transferable security must not compromise the AFM's ability to comply with its obligation to meet redemption requests.

4.8 However, the same rule states that, unless there is information available to the AFM that would lead to a different determination, a transferable security which is admitted to or dealt on an eligible market is presumed not to compromise this ability to redeem units. We refer to this as the 'listed asset presumption'.

4.9 The 'listed asset presumption' is qualified by the requirement for the AFM to consider whether there is any available information that would lead to a different determination. We would expect limited secondary trading, in absolute terms or relative to the size of the fund's holding in that security, to be such a factor. An AFM must also ensure that a UCITS scheme and a NURS aim to provide a prudent spread of risk and that the redemption terms of the fund align to its portfolio's liquidity.

4.10 So, our view is that the existing presumption does not allow an AFM to invest in a transferable security which is admitted to or dealt in on an eligible market without any consideration of that security's potential liquidity risk. However, we also believe that the 'listed asset presumption' sets an overly simplistic test – the fact that a security is admitted to an eligible market does not in itself determine its liquidity. For example, because some securities admitted to trading have very limited to no secondary trading, an AFM would need to consider very carefully whether any holding of these securities could risk compromising its ability to redeem units. So we propose removing the presumption to make clear that the AFM needs to carry out a case-by-case analysis of each transferable security's liquidity risk, taking into account, amongst other factors, the size of the portfolio's investment in that security.

4.11 To help AFMs make this assessment, we also propose to amend COLL 5.2.7BG to set out the factors which an AFM should consider when assessing whether a transferable security's liquidity might compromise its ability to meet redemptions. To do so, we propose replacing the cross-reference to the Committee of European Securities Regulators' (CESR) UCITS eligible assets guidelines with an updated version of the relevant key factors.

4.12 Under the new guidance provision, when assessing the liquidity risk of a transferable security, we would expect the AFM to consider:

a. The quality of secondary market activity in the transferable security, in terms of:

- the volume of transactions in that security over a reasonable period of time; and
- the number and quality of intermediaries and market-makers for that security.

b. how the fund's holding of (or size of the proposed transaction in) a transferable security that it might need to trade in the event of significant redemptions or subscriptions, compares to the average daily volume of trades in that transferable security.
c. The opportunities available to buy or sell the security and the time it may take to do this.
d. The proportion of the scheme property that the security would make up.

4.13 COLL 5.2.7FR states that an approved money-market instrument is one which is normally dealt on the money market, is liquid and has a value which can be accurately determined at any time. COLL 5.2.7HR (1) explains that a money-market instrument shall be viewed as liquid if it can be sold at limited cost in an adequately short time-frame, taking into account the AFM's obligation to redeem units at the request of any qualifying unitholder.

4.14 COLL 5.2.7HR (3) then applies a similar 'listed asset presumption' to a money-market instrument, to the effect that a money-market instrument that is normally dealt in on the money market and is admitted to or dealt in on an eligible market is presumed to be liquid and have a value which can be accurately determined at any time. This is unless there is information available to the AFM that would suggest otherwise.

4.15 Given the relatively short maturity and high quality requirements of approved money-market instruments, we consider they have a reduced liquidity risk. So we do not propose to remove the equivalent presumption of liquidity from COLL 5.2.7HR (3).

Question 11: Do you agree with removing the 'listed asset presumption' for transferable securities to avoid an AFM placing over-reliance on the fact that a transferable security is admitted to trading when assessing its eligibility?

Question 12: Do you agree with the factors that an AFM should consider when assessing the liquidity risk of a transferable security?

Question 13: Do you agree the 'listed asset presumption' should be retained for an approved money-market instrument?

Removal of the derogation from the eligible market test

4.16 COLL 5.2.8R (3) sets out the eligibility tests for holding transferable securities and approved money-market instruments within a UCITS scheme. COLL 5.6.5R applies broadly equivalent tests to a NURS.

4.17 In summary, UCITS schemes and NURS can invest in transferable securities and money-market instruments which are:

a. admitted to or dealt in on an eligible market (which is either a regulated market operated by a Recognised Investment Exchange (RIE); a market in the UK or an EEA state which is regulated, operates regularly and is open to the public; or any other market which satisfies the tests in COLL 5.2.10R (2));
b. approved money-market instruments not admitted to or dealt in on an eligible market, which satisfy the tests within COLL 5.2.10AR (1) (for example, that the issue or the issuer is regulated for the purpose of protecting investors and savings);
c. recently issued transferable securities, provided that:

- The terms of issue include an undertaking that application will be made to admit the securities to an eligible market.
- This admission is secured within a year of issue.

4.18 A maximum of 10% of the scheme property of a UCITS scheme and 20% of the scheme property of a NURS can be allocated to other kinds of transferable securities and money-market instruments, provided they satisfy the other tests in COLL 5.2. For example, their liquidity must not compromise the AFM's ability to redeem units. These allocations can be referred to as the 'unapproved securities buckets'.

4.19 We want to allow UCITS schemes and NURS to continue to participate in initial public offerings (IPOs). However, we consider any transferable securities which are not yet admitted to, or dealt in, on an eligible market should be held within the unapproved securities buckets. There is no explicit limit on the exposure an AFM can currently have to recently issued securities which are not yet admitted to an eligible market. However, an AFM must also consider its other obligations in terms of liquidity risk and risk management more generally, so we would not expect any UCITS scheme or NURS to have significant exposure to such securities. We think this derogation creates unnecessary uncertainty about the acceptable liquidity profile of these types of fund, so we propose to remove it.

4.20 We want to minimise the impact of this proposed change on AFMs and the risk of creating a 'cliff edge'. So we also propose a transitional provision to allow that, if a recently-issued transferable security is held within a scheme in line with the current rule on the day before the new rule commences, it can continue to be held like this until the date on which admission to an eligible market must be secured under the current rule.

4.21 For example, an AFM of a UCITS scheme invests in a recently issued but unlisted transferable security on 10 January 2026. The amended rules come into effect on 1 September 2026 (by way of example only). The AFM could hold that security outside of the scheme's unapproved securities bucket until 9 January 2027. On this date – if the security has not been admitted to an eligible market – the derogation will have expired and the AFM would need to either sell the security or allocate it to the unapproved securities bucket.

4.22 COLL 5.2.20R permits the underlying of a derivative to be a recently issued transferable security which has not yet been admitted to an eligible market (i.e.a security permitted for investment by a UCITS scheme under COLL 5.2.8R 3(e) (a recently issued security)). As we propose to remove the derogation in COLL 5.2.8R 3(e) to prevent a UCITS scheme from holding recently issued but untraded transferable securities outside of its unapproved securities buckets, we propose to also prevent a UCITS scheme from investing in a derivative which references such a security. The effect of COLL 5.6.4R 5(d) would be that this change carries across to a NURS. This is consistent with the current approach of not allowing UCITS schemes or NURS to enter into derivative contracts that reference unapproved transferable securities.

Question 14: **Do you agree with removing the derogation from the eligible market test for recently issued securities?**

Question 15: **Do you agree with the consequential change proposed to the rules on the approved derivatives in which a UCITS scheme and a NURS can invest?**

Question 16: **Do you agree that this proposal should have a limited impact on any fund's specific investment strategies? For example, that it should not limit a fund's ability to invest in IPOs? If not, please provide any data you can to support this.**

Eligible market requirements

4.23 A UCITS scheme and a NURS can invest in transferable securities and money-market instruments that are admitted to trading on any market which satisfies the tests in COLL 5.2.10R (2).

4.24 These requirements include that the market is regulated, operates regularly, is open to the public, and is adequately liquid. When assessing a market against these tests, we believe it is important for the AFM to consider whether and how those factors apply to the type of property in which the AFM intends to invest. For example, a market could generally be considered liquid, but there may be limited secondary trading for the specific transferable securities which the AFM intends to buy. So we propose a new guidance provision in COLL 5.2.10AAG which refers to this asset-specific assessment.

Question 17: Do you agree with our proposed guidance relating to eligible markets?

Treating all unitholders equitably

4.25 The nature of an open-ended fund means a conflict may arise between unitholders wanting to redeem their units and those wanting to stay invested. The AFM might be reluctant to sell less liquid assets with long-term potential to meet redemption requests. While the AFM must act in the best interests of remaining investors, it owes the same duty to redeeming investors.

4.26 To treat investors fairly, the AFM should assume that it meets a redemption request by selling a vertical slice of the portfolio, even if this includes securities which it deems to have strong growth potential. That does not mean an AFM would always be expected to sell a true vertical slice of the portfolio and we acknowledge that there are cases where it is not desirable or practical to do so, such as in the case of an MMF.

4.27 So we propose introducing a new rule (COLL 6.6.3R (5)) to require an AFM to explicitly consider potential conflicts of interest between remaining and redeeming investors, and the AFM's incentive to invest in less liquid or illiquid assets, when satisfying an obligation to meet redemption requests. This new rule mirrors the existing requirement for AIFs in Article 32 of Commission Delegated Regulation (EU) No 231/2013 (the AIFMD level 2 regulation) but would apply to UCITS schemes and NURS managed by small AIFMs. The requirement in the AIFMD level 2 regulation does not apply to the latter.

Question 18: Do you agree our proposed rule adequately captures the risks of conflicts of interest between those unitholders who want to redeem their units and those who want to remain invested?

Stress testing

4.28 Under COLL 6.12.11R, an AFM must, where appropriate, conduct stress tests to assess the liquidity risk of the UCITS scheme under exceptional circumstances.

4.29 We consider it would always be appropriate to carry out stress testing for a UCITS scheme and so we propose to remove the words 'where appropriate'. We also propose to require these tests to be carried out based on normal as well as exceptional market conditions, which we believe is already good market practice.

4.30 In July 2020, ESMA published guidelines on liquidity stress testing in UCITS schemes and AIFs. As the UK was in the transition period for leaving the EU at this time, these guidelines applied to UK fund managers. In the 2023 multi-firm review we said we expect stress tests to be carried out in line with them.

4.31 We propose to bring these guidelines into our Handbook and update them, although they remain broadly unchanged. We summarise these updates below.

4.32 The Investment Funds sourcebook (FUND) sets out the stress testing requirement for AIFs, so we will consult on any changes to it in the AIFMD review CP in 2026. However, before that consultation, and any subsequent changes coming into force, we propose to add a guidance provision to FUND 3.6. This would state that AIFMs of NURS should have regard to the guidance on liquidity stress testing which we propose to include in a new annex to COLL.

Updates to the ESMA guidelines

4.33 We propose making the following updates to the ESMA guidelines:

4.34 **Frequency of stress testing:** The guidelines currently state that liquidity stress testing should be carried out at least annually and, where appropriate, undertaken at all stages in a fund's lifecycle. However, this is then followed by a recommendation to carry out quarterly or more frequent liquidity stress testing. We have removed the reference to 'annually' so that the recommendation is simply quarterly or more frequent testing as the AFM considers appropriate.

4.35 **Liquidity stress testing scenarios:** The guidelines currently state that liquidity stress testing should employ hypothetical and historical scenarios and, where appropriate, reverse stress testing. Reverse stress testing is arguably the most important stress test that can be performed, so we propose to delete the words 'where appropriate' and make it a standard testing requirement.

4.36 The guidelines also state that historical scenarios for liquidity stress testing could include the global financial crisis 2008-2010 or the European debt crisis 2010-2012. We propose to remove the references to specific historical scenarios and instead state the historical events chosen should be the most appropriate to the fund's strategy.

4.37 **Redemption coverage ratio:** The guidelines currently state that, after separately stress testing the assets and the liabilities of the fund's balance sheet, the fund manager should combine the results of the liquidity stress tests to determine the overall effect on fund liquidity. The guidelines state that the manager's chosen approach should be explained and documented in the liquidity stress testing policy, particularly if it does not require the assessment of the time and/or cost to liquidate assets in a portfolio.

4.38 We think a fund manager's chosen approach would always have to require an assessment of the time and/or cost to liquidate assets, so we propose to remove this reference as unnecessary. In cases where an AFM opts to reduce its exposure to derivatives rather than liquidate assets to reduce risk and realise margin savings, we propose that the AFM should assess the time and/or cost to do so in a similar manner.

4.39 Non-redemption pressures: The guidelines currently state that net redemptions may not be the only relevant risk to liquidity coming from the liability side of a fund's balance sheet which should be subject to liquidity stress testing. They state that an AFM should include all other relevant types of liabilities in its liquidity stress testing in normal and stressed conditions and refer to different types of liabilities, including derivatives and securities financing transactions.

4.40 When incorporating derivatives and securities financing transactions in liquidity stress testing, an AFM should consider not only the potential for increases in variation margin and collateral calls due to adverse market price movements, but also the potential for counterparties to increase initial margins and haircuts. Further, the AFM should consider the risk that securities financing counterparties terminate or refrain from 'rolling over' existing financing arrangements in stress. We propose to incorporate these margin-related considerations as additional guidelines.

4.41 The FSB has made separate recommendations on liquidity preparedness for margin and collateral calls. So, to take account of these recommendations we have made clear that market participants should define their tolerance for liquidity risk from margin and collateral calls and establish contingency funding plans to ensure they can meet liquidity needs from these calls, including under extreme but plausible stressed conditions.

Question 19: Do you agree with our proposed approach to bring the ESMA liquidity stress test guidelines into the Handbook?

Question 20: Are there any other areas where you consider that updates or revisions to the guidelines would be appropriate? Please explain your rationale.

Guidance on good liquidity risk management practices

4.42 In recent years we set out our expectations on good liquidity risk management practices, including through 'Dear CEO' letters and multi-firm reviews. We propose to include a new annex in COLL which brings together the key principles that we have communicated to date, while also incorporating core aspects of the IOSCO recommendations and the FSB recommendations on margin and collateral preparedness.

4.43 The proposed guidance (COLL 6 Annex 4) sets out the key components of an effective liquidity risk management system, including:

- An effective liquidity risk management system relies on the liquidity of a fund's portfolio being consistent with its redemption policy. An AFM should decide an appropriate redemption policy by considering the fund's unique characteristics.
- The key features of an effective liquidity risk management system include appropriate liquidity thresholds proportionate to the fund's redemption obligations and other liabilities. For example, there should be a systematic and robust liquidity bucketing system which considers the time it would take to sell all or part of a holding under different market conditions. This will help to determine if the portfolio's liquidity profile is appropriate for the redemption policy and the AFM's expectations of how the investor base could behave in different market conditions.
- An AFM should closely monitor levels of redemption requests and have an appropriate internal trigger in place for both large redemptions and cumulative smaller redemptions, without relying solely on third-party administrators.
- When meeting redemption requests, an AFM should carefully consider the remaining investors' interests, especially where the fund holds less liquid assets. The AFM should avoid a scenario in which remaining investors in the fund are left with an increasingly illiquid portfolio.
- An AFM should choose the liquidity management tools which are most suited to the fund's investor base, investment strategy and liquidity profile. An AFM should have policies in place as to when it will consider using its liquidity management tools. These policies should be documented, sufficiently detailed and accessible to the relevant decision makers.
- An AFM should integrate liquidity stress testing into all stages of the fund's life cycle. This includes in the product design stage when deciding the dealing and distribution arrangements and portfolio composition, and in carrying out ongoing investment and liquidity risk management.
- The AFM should consider any risks from non-redemption pressures on the fund, such as any derivative or securities financing transactions to which it is party. The AFM should ensure the fund holds a sufficient quantity of liquid assets and eligible collateral to meet margin and collateral calls in a timely manner, including in extreme but plausible stressed conditions.
- The AFM should regularly assess the diversification of its eligible collateral and minimise its credit, liquidity and market risk, to ensure that the amount remains sufficient. The AFM may also consider the use of credit lines and/or collateral transformation agreements that can reduce the need to hold cash collateral, where appropriate.

- An AFM should have adequate collateral management systems and processes to ensure the timely delivery of margin calls, including during stressed conditions. When designing these systems and processes, the AFM should consider the costs and benefits of (i) outsourcing certain aspects to third parties, (ii) standardisation and/or automation to maximise capacity to make timely delivery during periods of heightened market activity and (iii) holding excess collateral in normal market conditions to reduce the impact of increased margin and collateral calls during stressed conditions.
- An AFM should be able to (i) identify potential intra-day margin and collateral call requirements and ensure capacity to make timely delivery, (ii) monitor the amounts of readily available cash and non-cash collateral and ensure that they are (pre-) positioned in the currency and location necessary to make timely delivery and (iii) identify, monitor, and manage collateral disputes.
- An AFM should periodically review these systems and processes including by testing their operational readiness and the resilience of third-party service providers under stressed conditions, including that collateral is free from encumbrance and accessible in a timely manner, particularly when using re-hypothecation. The AFM should also conduct regular dialogue with counterparties and third-party service providers to identify potential liquidity risks under stressed conditions and manage the risks identified.

Question 21: Do you agree that the new guidance proposed in COLL 6 Annex 4 adequately captures the key components of an effective liquidity risk management system?

Proposed change	Intended effect	Proposed application
Purpose of chapter (COLL 5.1.2G)	To make clear the rules on the spreading of risk aim to protect investors from potential losses if, for example, a scheme is overly concentrated in a small number of investments, or cannot raise enough liquidity to meet redemption demands on a timely basis.	This proposed guidance would apply to all UCITS schemes and NURS, including those that are MMFs.
Investment in transferable securities (COLL 5.2.7AR)	To clarify that a transferable security must fulfil the stated criteria at the time of its acquisition and for as long as it is part of the scheme property.	This proposed rule change would apply to all UCITS schemes and NURS, including those that are MMFs.
Remove the 'listed asset presumption' (COLL 5.2.7AR)	An AFM would not be able to presume that the liquidity of a transferable security would not compromise its ability to redeem units, solely on the basis that the security is admitted to an eligible market.	This proposed rule change would apply to all UCITS schemes and NURS, including those that are MMFs.
Guidance on factors an AFM should take into account when assessing a transferable security's liquidity (COLL 5.2.7BG)	This sets out the factors which an AFM should take into account when assessing whether a transferable security could compromise its ability to redeem units.	This proposed rule change would apply to all UCITS schemes and NURS, including those that are MMFs.
Remove the derogation from the eligible market test for recently issued securities (COLL 5.2.8R and COLL 5.6.5R (1))	An AFM could invest in such securities only if they are allocated to the fund's unapproved securities buckets.	This proposed rule change would apply to all UCITS schemes and NURS, including those that are MMFs.
Eligible market: requirements (COLL 5.2.10AAG)	To clarify that, when considering whether a market that operates regularly and is open to the public is adequately liquid, the AFM should apply the test to the type of property in which the AFM intends to invest.	This proposed guidance would apply to all UCITS schemes and NURS, including those that are MMFs.
Permitted transactions (derivatives and forwards) (COLL 5.2.20R)	An AFM would not be able to invest in a derivative which references a recently issued security which has not yet been admitted to an eligible market.	This proposed rule change would apply to all UCITS schemes and NURS, including those that are MMFs.

Proposed change	Intended effect	Proposed application
Conflicts of interest between transacting investors and remaining investors (COLL 6.6.3R (5))	An AFM would need to consider conflicts of interest between transacting investors and those which remain invested in the fund.	This proposed rule would apply to all UCITS schemes and NURS, including those that are MMFs.
UCITS stress testing requirement (COLL 6.12.11R)	An AFM would need to carry out stress testing to assess the liquidity risk of the UCITS scheme under both normal and exceptional test cases, rather than the current position which only requires the AFM to consider liquidity risk under exceptional circumstances.	This proposed rule change would apply to all UCITS schemes, including those that are MMFs. However an MMF manager also must take account of other requirements, eg those in MMFR.
Liquidity stress test guidelines	We would bring the ESMA guidelines into the Handbook with some updates.	This proposed guidance would apply to all UCITS schemes and NURS, including those that are MMFs to the extent set out under new COLL Annex 5, para 2.3G.
Guidance on good liquidity risk management practices	We would set out our expectations on what a strong liquidity risk management system should cover.	This proposed guidance would apply to all UCITS schemes and NURS that are not MMFs.

Chapter 5

Delegation of the portfolio management function

5.1 AFMs often delegate the portfolio management function to a third party – whether another entity within the same group or outside of it. In some cases, the AFM is referred to as a 'host AFM'. This refers to an arrangement where an AFM agrees to operate a fund for a MiFID investment manager that has significant influence over the fund's design, distribution and management. The MiFID investment manager is often referred to as the 'sponsor'.

5.2 We do not propose making any new rules for, or guidance on, the host AFM arrangement in the context of liquidity risk management at this time. We consider the existing framework and expectations for both parties are sufficiently clear. The Decision Notices issued to WIM and Mr Woodford explain the distinct but complementary responsibilities of the AFM and MiFID investment manager in ensuring that an appropriate liquidity risk management framework is established and followed.

5.3 Under a host AFM arrangement, the MiFID investment manager has responsibility for discretionary investment management and advisory services, with a view to achieving the fund's investment objectives as set out in its prospectus. However, whether or not it has delegated the portfolio management function, the AFM retains ultimate responsibility for the fund's liquidity risk management, so that:

- Redemption requests can be met in line with the fund's redemption policy.
- All investors are treated fairly and those remaining in the fund are not disadvantaged versus those choosing to redeem.
- The fund's portfolio provides for a prudent spread of risk.

5.4 The AFM would be expected to take swift remedial action if it became aware that the MiFID investment manager was not acting in a way that achieved these outcomes. For example, if the AFM had reason to believe that the MiFID investment manager was using inappropriate metrics to assess the portfolio's liquidity, or its liquidity had deteriorated to the point that it was no longer consistent with the fund's redemption policy.

5.5 The MiFID investment manager also has a responsibility to implement the liquidity risk framework effectively, as set out in its investment management agreement. The MiFID investment manager must manage the fund's liquidity so it remains consistent with its redemption policy, and attach adequate weight to liquidity considerations when deciding which assets to buy, retain or sell. It must also respond promptly to any warning signs that the fund's liquidity is deteriorating.

5.6 Irrespective of the allocation of day-to-day responsibilities for managing the fund, both the AFM and the MiFID investment manager must exercise due care, skill and diligence (Principle 2) and pay due regard to the interests of investors and treat them fairly (Principle 6).

Question 22: Do you agree with our decision not to propose any new rules or guidance in relation to host AFM arrangements?

Chapter 6

Looking ahead to the 2026 AIFMD review consultation

6.1 In 2026, we plan to consult on AIFMD reforms, including updated liquidity rules for AIFs. As the current framework for AIFs aligns well with IOSCO recommendations, we expect to propose only relatively small changes.

6.2 We recognise that there is great variation in the different types of AIF. In April 2025, we published a Call for Input on future regulation of AIFMs. In it we said that we propose an approach that is proportionate to firms' size and activities, allowing for growth without sudden or undue regulatory burdens. We therefore want our rules to reflect the size and complexity of different AIFMs' operations.

6.3 For example, we recognise that listed closed-ended investment companies (investment trusts) have unique characteristics and so we propose to take account of the specific nature of that market and their wider regulatory framework.

6.4 However, there have been some cases of liquidity mismatch in AIFs in recent years, mainly in authorised property funds. Despite existing rules on matching redemption policies with portfolio liquidity, many daily-dealt property funds have had to suspend dealings for extended periods due to valuation and liquidity problems.

6.5 We consulted on proposals in 2020 to require NURS property funds to have mandatory notice periods, but we never finalised the rules. As part of the AIFMD consultation in 2026, we will reconsult on proposals to require some authorised AIFs invested in inherently illiquid assets such as real estate to have minimum notice periods. This would bring them in line with the LTAF regime. We consider most other authorised funds already have appropriate redemption terms. We intend to give AIFMs of unauthorised AIFs more flexibility to choose how to manage the liquidity offered to investors.

6.6 Stakeholder feedback to the 2020 consultation highlighted that the fund distribution system is not well prepared to support funds with notice periods. Despite some progress, we know challenges remain and we continue to engage with industry to help find solutions.

6.7 We intend to give firms a reasonable period of time to adapt. However, their operational challenges should not prevent us protecting investors by addressing the liquidity risks in certain funds. In the long term, enabling fund distribution chains to support a wider range of funds, including those with notice periods, will benefit UK competitiveness.

6.8 We also plan to introduce a baseline of liquidity management rules for small AIFMs, who are currently not subject to any rules on how they manage fund liquidity. At a minimum, for open-ended funds, we propose to require consistency between the fund's redemption policy and the liquidity of its portfolio.

6.9 In light of the FSB recommendations on margin and collateral (December 2024) and leverage in nonbank financial intermediation (July 2025), we will also review the leverage rules for different types of AIF. Using high levels of leverage creates risk, both to AIF investors and potentially to wider financial markets and we want to set appropriate standards for firms that do this. It is also important that we can measure, monitor and manage the risks of high leverage in AIFs, and we are considering if we need to be clearer about our expectations of risk management by highly leveraged firms.

Annex 1

Questions in this paper

Question 1: Do you have any comments on the ESG implications of our proposals?

Question 2: Do you have any comments on the equality and diversity implications of our proposals?

Question 3: Do you agree that we should require all AFMs of UCITS schemes and NURS to have anti-dilution tools available for use, if they do not already do so?

Question 4: Do you agree that the three anti-dilution tools available to an AFM should be dual-pricing, a dilution adjustment or a dilution levy? If not, what other tools do you think should be available and why?

Question 5: As a possible alternative, do you believe that having the ability to close a fund to new investors only ('soft close') would enhance the fund's ability to avoid dilution?

Question 6: Do you agree that the position for LTAFs and QIS should be considered separately as part of the 2026 AIFMD review CP?

Question 7: Do you agree with the factors included in the proposed guidance regarding calibration of anti-dilution tools, for example that an AFM should take into account both explicit and implicit costs when calibrating its anti-dilution tools?

Question 8: Do you agree that the AFM of a UCITS scheme and a NURS should be required to annually review the effectiveness of its anti-dilution policies to ensure all unitholders have been treated fairly?

Question 9: Do you agree with our proposed approach for dual-priced funds? Do you anticipate there may be any other implications of our proposals beyond those explained above?

Question 10: Do you have any other comments on our proposals relating to anti-dilution tools?

Question 11: Do you agree with removing the 'listed asset presumption' for transferable securities to avoid an AFM placing over-reliance on the fact that a transferable security is admitted to trading when assessing its eligibility?

Question 12: Do you agree with the factors that an AFM should consider when assessing the liquidity risk of a transferable security?

Question 13: Do you agree the 'listed asset presumption' should be retained for an approved money-market instrument?

Question 14: Do you agree with removing the derogation from the eligible market test for recently issued securities?

Question 15: Do you agree with the consequential change proposed to the rules on the approved derivatives in which a UCITS scheme and a NURS can invest?

Question 16: Do you agree that this proposal should have a limited impact on any fund's specific investment strategies? For example, that it should not limit a fund's ability to invest in IPOs? If not, please provide any data you can to support this.

Question 17: Do you agree with our proposed guidance relating to eligible markets?

Question 18: Do you agree our proposed rule adequately captures the risks of conflicts of interest between those unitholders who want to redeem their units and those who want to remain invested?

Question 19: Do you agree with our proposed approach to bring the ESMA liquidity stress test guidelines into the Handbook?

Question 20: Are there any other areas where you consider that updates or revisions to the guidelines would be appropriate? Please explain your rationale.

Question 21: Do you agree that the new guidance proposed in COLL 6 Annex 4 adequately captures the key components of an effective liquidity risk management system?

Question 22: Do you agree with our decision not to propose any new rules or guidance in relation to host AFM arrangements?

Annex 2

Cost Benefit Analysis

Executive Summary

1. Effective liquidity risk management is essential for open-ended funds to protect investors and maintain financial stability. A key principle is that a fund's liquidity profile must align with its redemption terms, ensuring that investors can redeem their investments as expected and that markets remain orderly.

2. In response to evolving international standards, the FCA has actively contributed to the development of revised recommendations on fund liquidity risk management by IOSCO and the Financial Stability Board (FSB). These new standards aim to implement the FSB and IOSCO recommendations on fund liquidity risk management and, in doing so, address vulnerabilities arising from liquidity mismatches in open-ended funds.

3. While the FCA Handbook already has a comprehensive framework in place, recent supervisory work has highlighted areas where rules could be clarified or strengthened. The proposed changes in this consultation paper focus on AFMs of UCITS schemes and NURS, aiming to enhance liquidity risk management – especially for funds holding less liquid assets – without requiring fundamental changes to AFMs' overall approach or their responsibility to act in investors' best interests.

4. Poor liquidity mismatch management can result in:

   - Risk of redemption costs – both explicit (e.g. transaction fees) and implicit (e.g. market impact) – being inaccurately assigned between unitholders. This means that residual investors, predominantly retail, are exposed to dilution in the value of their holdings and a progressive deterioration in the fund's portfolio liquidity.
   - Potential opportunities for first movers to benefit from early redemptions but harm occurring for remaining investors who may be left with an increasingly illiquid portfolio following outflows.
   - Adverse selection risks for retail investors, who may not appreciate that the AFM could struggle to sell large quantities of securities quickly to meet high levels of redemption requests. This could leave such funds vulnerable to stress events.

5. To enhance funds' liquidity risk management, we are proposing changes to promote the effective use of anti-dilution tools (such as swing pricing) by AFMs of UCITS schemes and NURS, and to ensure that AFMs of UCITS schemes and NURS have robust liquidity risk management processes, especially where they have exposure to less liquid assets.

6. Without our intervention, we consider AFMs would continue to use anti-dilution tools in the way which they currently do. We consider that AFMs which do not yet have anti-dilution tools available are unlikely to introduce these tools without our intervention. While we consider the existing rules provide for a high standard of liquidity management by AFMs of UCITS schemes and NURS, we believe some AFMs may be unlikely to proactively consider whether they can improve their liquidity management practices in the absence of our amended rules and new guidance.

7. Overall, we expect the proposals to deliver a net benefit through reducing the probability of individuals' financial loss, making the distribution of costs more efficient, supporting orderly markets, and improving the resilience of UK funds.

8. The estimated Present Value (PV) cost of our proposals over a 10-year period is estimated as approximately £13.74m. This is made up of direct familiarisation and compliance costs to AFMs and other related market participants. We do not consider the new requirements on AFMs of UCITS schemes or NURS should produce any material cost for investors, nor should they notice any change in the way they interact with the AFM or its delegates, or affect underlying business models. That is because we do not expect AFMs will need to make any material changes to the portfolios of the funds they manage in response to our interventions.

9. We expect our proposals to have a positive indirect economic impact. The proposals aim to ensure efficient and stable markets by requiring AFMs to have anti-dilution tools, while keeping regulation proportionate and avoiding unnecessary complexity or international divergence. These measures are designed to strengthen trust, support innovation and competition, and maintain market stability by enabling AFMs to manage liquidity risks effectively and fairly. We believe our approach balances robust liquidity management with flexibility for AFMs, supporting both investor confidence and the international competitiveness of UK funds.

10. Following implementation, we will monitor how effectively firms implement our amended rules and guidance on anti-dilution tools. This may include supervisory spot checks and outlier analysis, monitoring at the authorisations gateway, or a future survey or multi-firm review.

Introduction

11. The Financial Services and Markets Act (2000) requires us to publish a cost benefit analysis (CBA) of our proposed rules. Specifically, section 138I requires us to publish a CBA of proposed rules, defined as 'an analysis of the costs, together with an analysis of the benefits that will arise if the proposed rules are made'.

12. This analysis presents estimates of the significant impacts of our proposal. We provide monetary values for the impacts where we believe it is reasonably practicable to do so. For others, we provide a qualitative explanation of their impacts. Our proposals are based on weighing up all the impacts we expect and reaching a judgement about the appropriate level of regulatory intervention.

13. The CBA has the following structure:

- The UK authorised fund market
- Problem and rationale for intervention
- Options considered and our proposed intervention
- Baseline and key assumptions
- Summary of impacts
- Benefits
- Costs
- Wider economic impacts
- Monitoring and Evaluation

The UK authorised fund market

UK authorised funds and fund managers

14. A fund is an investment vehicle that pools together money from many different investors. It is operated by a fund manager whose duties include buying, holding and selling underlying investments on behalf of investors. Funds can invest in various types of assets, such as shares, bonds or property, depending on the fund's investment objective.

15. Retail and institutional investors use funds to generate a return on their investments. Retail consumers may use funds to save for retirement, support a large purchase or earn higher returns than holding their assets in a savings account. Institutional investors typically use funds to get better returns on money that otherwise would be stored as cash or to meet future expected or potential liabilities and cash flow requirements.

16. According to the Investment Association (IA), the net asset value (NAV) of UK authorised funds (funds regulated by the FCA, including retail products) in September 2025 was £1.58 trillion growing from £1.49 trillion in September 2024. The UK is the second largest investment management centre in the world, second only to the US, with the UK managing £5.1 trillion in overseas client assets under management (AUM). Authorised funds, as a low-cost pooled vehicle, play a key role in the distribution of investment management services.

17. Fund managers may manage either authorised or unauthorised funds. Where they manage an authorised fund (a UCITS, NURS, qualified investor scheme (QIS), money market fund (MMF) or long term asset fund (LTAF), they are an AFM. If they manage a NURS, QIS, LTAF, or MMF which is an alternative investment fund (AIF), they are also an alternative investment fund manager (AIFM). If they manage a UCITS, including an MMF which is a UCITS, they are a UCITS management company. AIFMs may also manage unauthorised AIFs, however the focus of this consultation is on authorised funds.

18. Our interventions are targeted at AFMs of UCITS schemes and NURS. In the UK currently there are 166 AFMs with permission to operate a UCITS scheme or an authorised AIF (a NURS, LTAF, QIS or MMF), of which 104 are managing an active authorised fund. 94 AFMs manage a UCITS scheme and/or a NURS.

Anti-dilution tools

19. Open-ended funds can have a structural mismatch between the liquidity they offer investors and the time it takes to buy or sell assets. This mismatch between redemption terms and the liquidity of funds' assets is referred to as liquidity mismatch.

20. Funds use a set of anti-dilution tools available to manage any liquidity mismatch. The anti-dilution tools available to an AFM are either dual-pricing or, in the case of a single-priced fund, a dilution levy (liquidity fee) or a dilution adjustment (swing pricing). Whereas the effect of dual-pricing should be that the AFM always calculates the bid-ask spread so it counters any dilution effect, in the case of a single-priced fund the AFM must use its discretion to decide when to apply its anti-dilution tools.

21. The results of the 2020 joint survey with the Bank of England on liquidity management in UK open-ended funds found the majority of AFMs use anti-dilution tools. 51 AFMs responded to the survey on behalf of 272 funds. 244 (90%) of these funds were single-priced and AFMs of 202 funds (83% of single-priced funds) responded they had a dilution adjustment only. AFMs of 36 funds (15%) reported a dilution levy only, and the AFM of 1 fund reported both a dilution levy and dilution adjustment. 4 AFMs of 5 funds (2% of funds) reported neither, however 2 of these AFMs did submit responses for other funds which had a form of anti-dilution tool available. This means 4 out of the 51 AFMs managed a fund without any form of dilution tool available (8%). The AUM of these 5 funds in October 2025 was at least £2.049 billion.

Other participants

22. As a fund manager, a UCITS management company or an AIFM of an authorised AIF both have the functions of portfolio management and risk management. A UCITS management company or an AIFM are therefore responsible for setting the investment strategy and redemption terms, and ensuring the liquidity profile of the fund remains consistent; putting in place an appropriate risk management system, including liquidity risk; managing the fund's portfolio so it is able to meet redemptions under the terms set out in the fund's prospectus, and adjusting the portfolio to respond to market developments and emerging risks.

23. These functions, along with any ancillary functions, can be delegated to a third party, which, if in the UK, would be a MiFID investment manager. However, this can only be done to the extent the AIFM or the UCITS management company does not become a 'letter box' entity. The AIFM or the UCITS management company remain ultimately responsible for compliance with their regulatory obligations.

24. Many investors, particularly retail investors, will access funds via **investment platforms** and therefore do not interact directly with the fund manager when choosing to invest or redeem. Investment platforms provide an online platform which allows investors to buy, manage and sell their investments. Investment platforms therefore provide access to information and tools to inform and help with investment choices, provide tax efficient wrappers, such as Self-Invested Personal Pensions (SIPPs) and Individual Savings Accounts (ISAs), process investment transactions, report on the performance and valuation of investments, and carry out administration functions, such as the payment of adviser charges.

25. **Depositaries** also play an important role in the fund management ecosystem. A UCITS management company or a full scope AIFM is required to appoint a depositary which will be responsible for the safekeeping of assets in the fund and other oversight functions, such as cash flow monitoring. Under COLL 6.6.4R, the depositary has a general duty to take reasonable care to ensure the scheme is managed in accordance with the rules on investment and borrowing powers; valuation and pricing; and accounting, allocation and distribution of income; amongst others.

26. We estimate there are 344 delegated MiFID fund managers - this is likely an over-estimate, as our estimate is based on AFM relationships with MiFID managers, but some MiFID managers will have a relationship with more than one AFM. In addition to the fund managers, 44 relevant distributor firms, including direct-to-consumer platforms, advised platforms and direct distribution platforms operate as intermediaries between investors and AFMs in the market while 14 firms act as depositaries to UK UCITS and authorised AIFs. The changes to liquidity rules for AIFMs of unauthorised AIFs will be set out in the AIFMD reform consultation next year, however, we provide an overview of these changes in Chapter 6.

Regulation

27. The Collective Investment Schemes sourcebook (COLL) in the FCA Handbook sets out a comprehensive framework for how fund managers should manage the liquidity of a fund, a fundamental principle being that the fund's liquidity profile must be consistent with its redemption policy. Depending on the type of fund, additional rules seek to ensure the AFM operates the fund in a way that aligns with what its target investor base would expect. For example, a manager of a UCITS scheme and a NURS must provide for a prudent spread of risk and meet the specified concentration rules.

Problem and rationale for intervention

28. In this section we discuss the problems and harms that our proposals seek to address and underlying drivers (or market failures) that bring about these harms.

Rationale for intervention

29. Although we do not believe that fundamental changes are needed to the existing framework and have observed some good practices, we believe that more can still be done to improve liquidity risk management in open-ended funds. We have therefore identified specific areas where we can enhance our rules and provide additional guidance.

30. We consider that there are risks of harm when AFMs of UCITS schemes and NURS lack, or ineffectively use, anti-dilution tools. Without proper use or calibration, remaining investors may face increased portfolio illiquidity including by 'first mover advantage' when liquid assets are depleted.

31. If a UCITS scheme or NURS invests in less liquid securities, or holds investments of a size that is challenging for available liquidity, without an appropriate liquidity risk management system in place, funds are more exposed to stress events, whether

fund-specific or market-wide. Investors, especially retail, may not realise the risk of the AFM being unable to sell less liquid assets quickly to meet redemption requests.

Description of harm

Loss of access to capital

32. Poor liquidity risk management can result in harm to investors and potentially risk the resilience of the UK authorised fund market. Liquidity mismatch between funds' assets and redemptions can lead to suspension of funds (although rare) and cause significant harm to investors by restricting investors' access to capital and potentially favouring first-mover investors. In turn, market integrity and confidence in the UK's fund management sector would be undermined.

Gaps in funds' liquidity resilience

33. Our previous market studies, such as the 2023 liquidity management multi-firm review, have identified areas for improvement in fund managers' liquidity risk management systems, including how they assess the liquidity of assets in a fund's portfolio, their use of liquidity management tools and the governance attached to these processes.

34. The 2020 joint survey with the Bank of England also found areas for improvement of fund liquidity management. For example, the survey found that in most cases funds with different primary strategies and assets, but managed by the same fund manager, used the same thresholds for applying swing pricing and the same method for calculating the standardised swing factor. This indicated fund managers may not be fully considering specific factors such as the investor base or asset-specific factors for individual funds when using anti-dilution tools.

Misaligned costs

35. To manage their liquidity mismatch, funds should have a set of anti-dilution tools available to use. Where anti-dilution tools are not used, or used but not calibrated effectively, there is a risk the dilution deduction does not represent the true cost of liquidating a vertical slice of the portfolio. Where this occurs, the costs incurred on behalf of the fund may be inaccurately assigned between subscribing, remaining and redeeming investors. Some investors may over-estimate the liquidity of assets within the funds they invest in and may not anticipate the additional costs or complexities involved in funds liquidating positions or rebalancing portfolios to meet redemptions, especially during periods of market stress.

Misaligned investment decisions and fund liquidity

36. To effectively manage liquidity risks, AFMs should also exercise prudent judgement in selecting and maintaining asset holdings, ensuring that investment decisions are aligned with the fund's liquidity profile and redemption obligations.

37. We are confident the existing rules make it clear that, just because a transferable security is admitted to an eligible market, an AFM cannot proceed to invest without any further consideration of how the holding of this security might affect the fund's overall liquidity profile. This does not override the obligation on the AFM to act with due skill, care and diligence or to manage the fund in the best interests of all its investors. However, we believe the 'listed asset presumption' (explained in chapter 4) is overly simplistic and does not reflect the broad spectrum of liquidity on which transferable securities admitted to trading sit.

38. The ability of an AFM of a UCITS scheme and NURS to treat recently issued transferable securities, which have not yet been admitted to an eligible market, as approved securities means that harm can emerge such as where a fund can gain exposure to inherently illiquid securities (including beyond what is permitted by its 10/20% unapproved securities buckets). We consider that this existing derogation could harm investors by enabling a liquidity mismatch in which a UCITS scheme or a NURS gain a level of exposure to inherently illiquid assets that does not correspond to its redemption terms or the level of risk expected by investors. In such circumstances, investor decisions may be misaligned from fund liquidity. The derogation also creates uncertainty about the acceptable liquidity profile of these types of funds. Given these harms, we propose to remove this derogation. We do not have reporting which allows us to assess the extent to which AFMs currently rely on this derogation. However, we do not expect any UCITS scheme or NURS have significant exposure to this type of transferable security given the need to provide for a prudent spread of risk and align the liquidity profile of the fund with its redemption policy.

Drivers of harms

39. We consider there is a risk of investor harm from the following drivers:

- Externalities
- Adverse selection

Externalities

40. Investor fund transactions, such as selling out of a fund or buying into a fund, can have indirect consequences for other investors in the fund or market. This can occur even though the other investors are third parties and are not direct participants in a transaction, known as externalities. Negative externalities occur where an investor makes a transaction that has adverse consequences for the third-party investors such as increasing costs. These negative externalities comprise both explicit costs (e.g. transaction fees incurred by the fund) and implicit costs (e.g. an adverse market impact from the transaction's impact on the value of assets held by the fund). A dilution of the value of the fund from negative externalities is most likely to occur where there are significant inflows or outflows from a fund but the value of the remaining investor's investment can be gradually diluted over time even with continuous small outflows.

41. Negative externalities create an incentive for investors to sell their investments ahead of others to gain a first-mover advantage by avoiding the costs of other investor transactions. First-mover advantage can incentivise accelerated redemptions during periods of poor fund performance or market crisis, thereby increasing outflows and

negative externalities as the AFM is more likely to meet redemption requests through selling the most liquid assets in the portfolio. As a result, residual investors, who are predominantly retail, are exposed to dilution in value of their holdings and a progressive deterioration in portfolio liquidity. This dynamic also generates wider negative externalities for the market as it heightens the risk that other funds with similar assets will experience outflows and the same first mover advantage and negative externality dynamic.

Adverse selection

42. We believe UCITS schemes and NURS invested in less liquid transferable securities can pose risks to fund resilience. These risks arise when the AFM does not have a sufficiently robust liquidity risk management system with retail investors especially exposed through adverse selection. For instance, retail investors may not appreciate the risk that the AFM could struggle to sell large quantities of these securities within a short period of time to meet high levels of redemption requests. This could mean such a fund is more vulnerable to stress events which are both fund-specific (e.g. poor investment performance which leads to significant outflows), and market-wide (e.g. a change in interest rates which leads to increased collateral calls from counterparties).

Options considered and our proposed intervention

43. To address the above risks of harm arising from the absence or ineffective use of anti-dilution tools, we considered different options which are summarised in table below.

Table 1- Summary of options considered and their assessment

Option Considered	Assessment and Rationale
Requiring all AFMs to have anti-dilution tools available for use and setting out in rules when these should be activated (e.g. redemptions as a percentage of NAV) and how these should be calibrated (e.g. the factors which the AFM must consider).	We chose not to proceed with this option because rules that standardise practices for activating anti-dilution tools would give investors clarity on their use, but fixed thresholds may not suit all funds and could allow some investors to predict and exploit their use.
Requiring all AFMs to have anti-dilution tools available for use and policies which set out how they will identify dilution and assess its impact on unitholders; and providing guidance on the internal governance which should be attached to the use of these tools and the factors to be taken into account when calibrating them.	We consider this option best aligns with our objectives of protecting consumers and the integrity of the UK's financial system, while also promoting effective competition in the best interests of consumers. This is based on the principle that an AFM should remain ultimately responsible for the management of the fund.
Introducing no new rules, but providing guidance on the internal governance which should be attached to their use and the factors to be taken into account when they are calibrated.	We chose not to proceed with this option because, although the benefits would be broadly the same as our chosen approach, it would not close the gap for the small minority of AFMs which do not have these tools available.

44. While we consider there are potential harms associated with ineffective use of anti-dilution tools, we believe these harms are greater where anti-dilution tools are not used at all. We therefore intend to focus on the availability of the anti-dilution tools, so an AFM is required to have these tools available and use them to protect unitholders from any material dilution risk, while the decision of when and how they are calibrated remains at the discretion of the AFM.

45. We recognise this approach will allow variation in how AFMs apply and calibrate their anti-dilution tools, however, we do not believe it is desirable to standardise the calibration of these tools across all funds. To mitigate any risks which might arise from variation in their use, we propose to require that an AFM reviews at least annually its dilution policy's effectiveness in ensuring fair treatment of investors in each fund. This should help ensure that AFMs are making good use of their ability to tailor the calibration of these tools to their funds' unique circumstances.

46. We propose not to apply the requirement to have anti-dilution rules available to an LTAF, QIS or an MMF, meaning that if an AFM only managed one of these funds and did not also manage a UCITS scheme or NURS, they would not be affected by these proposals. However, out of the 104 active AFMs, only 10 do not manage a UCITS scheme or a NURS.

47. Our proposals intend to address harms by closing the gap for AFMs that do not have anti-dilution tools available to them. We also aim to improve the calibration of these tools where they are already in place. This will help ensure that the value of investors' investments is not diluted over time by the costs associated with subscriptions and redemptions. These proposals are explained in chapter 3.

48. For strong liquidity risk management processes by AFMs of UCITS scheme and NURS, we have also considered various options which are listed in Table 2 below.

Table 2 – Summary of options considered and their assessment

Option Considered	Assessment and Rationale
Removing the 'listed asset presumption' for transferable securities admitted to or dealt in on an eligible market.	We consider that the presumption is overly simplistic and an AFM should not presume that the liquidity of a transferable security would not compromise its ability to redeem units solely on the basis that the security is admitted to an eligible market.
Removing the derogation from the eligible market test for recently issued securities which have not yet been admitted to an eligible market.	We think this derogation creates unnecessary uncertainty about the acceptable liquidity profile of UCITS and NURS. We consider that any transferable securities which are not yet admitted to an eligible market should be held within the unapproved securities buckets.
Providing guidance on good liquidity risk management practices.	We consider it would be helpful to set out expectations on good liquidity risk management practices, bringing together in one place the messages we have communicated over recent years and the key principles of the IOSCO recommendations.

Option Considered	Assessment and Rationale
Requiring AFMs to consider conflicts of interests between investors wanting to exit the fund and those wanting to remain invested.	We consider that the nature of an open-ended fund means a conflict may arise between unitholders wanting to redeem their units and those wanting to stay invested. That is because the AFM might be reluctant to sell less liquid assets with long-term potential to meet redemption requests. We believe it is beneficial to require the AFM to consider how it will manage any conflicts between the interests of remaining and redeeming investors.
Bringing the ESMA liquidity stress test guidelines into the Handbook with some updates.	We have already made clear that we expect AFMs to follow these, however in bringing these into the Handbook we believe it helpful to make small updates to clarify our expectations on the frequency of stress testing, the role of reverse stress testing and how AFMs should consider risks arising from non-redemption pressures.
Requiring AFMs to publish stress test results.	We do not believe this would provide a material benefit unless there were some form of standardising these results. This would be costly to implement and of limited use to retail investors. We are not proposing this.
Reducing the maximum proportion of assets that a UCITS scheme and a NURS can hold in their unapproved securities buckets.	We do not consider that doing so would materially improve AFMs' liquidity risk management processes. It could force AFMs to sell significant amounts of existing holdings, potentially on disadvantageous terms, to bring their portfolios in line with the revised limits. We are not proposing this.
Prohibit UCITS schemes or NURS from investing in less liquid transferable securities, or set a limit on the proportion of less liquid transferable securities which can be held in the portfolio.	This could significantly affect a large number of AFMs, such as those which manage small companies funds or corporate bond funds. For example, proposing prescriptive rules on the types of transferable security which a UCITS scheme or NURS could invest in might require some AFMs to significantly rebalance fund portfolios, alter fund investment objectives and policies, or withdraw their funds from the UK market. This could have a negative impact on UK markets and consumer outcomes. We are not proposing this option.
Requiring that less liquid transferable securities which are admitted to an eligible market are held within the unapproved securities buckets and counted against the same maximum.	We consider it possible to mitigate the risks of holding such securities through an appropriate liquidity risk management process. The liquidity of all transferable securities will vary depending on market conditions and so we believe it should ultimately be the decision of the AFM as to whether a security's liquidity makes it appropriate for a fund or whether it could risk compromising its ability to redeem units. We are not proposing this option.

49. Our proposals are intended to advance proportionate regulation and effective competition in the interests of consumers to further our secondary objective for growth and international competitiveness. We are also furthering our secondary objective by addressing, but not exceeding, IOSCO recommendations to retain the international competitiveness of the UK asset management sector. Our proposals also support growth by refraining from a more prescriptive approach while achieving the benefits of improved fund resilience and confidence in the UK asset management sector. We do not expect that the problems and harms we identify will require AFMs to make significant changes in how they approach liquidity risk management. We propose harms can be addressed by retaining the principle that an AFM is ultimately responsible for the management of a fund in the best interests of its investors.

50. We do not consider that the problems and harms require a new liquidity classification framework as we recognise the liquidity of any security can vary depending on market conditions. However, we consider certain types of security to present greater risks of having limited liquidity, such as small cap equities and corporate bonds. Therefore, a strong liquidity risk management process is especially important for funds with investment strategies which focus on less liquid assets.

Causal chain

51. Below we illustrate the steps through which our proposed interventions drive firm changes to reduce harm and affect outcomes in line with FCA objectives, including for our Secondary International Competitiveness and Growth Objective (SICGO).

52. Our proposals for requiring AFMs to have anti-dilution tools available seek to (i) reduce harms from negative externalities from investor sales, (ii) align investor incentives with costs to protect remaining investors, and (iii) address harms arising from incentives to fire-sale assets. We consider these proposals will support sustainable and long-term growth and improve or maintain international competitiveness. For liquidity management of UCITS schemes and NURS, our proposals intend to (i) reduce harm from liquidity mismatch and (ii) enhance the resilience of funds. Growth is supported by improved international competitiveness, competition and market confidence.

Figure 1: Anti-dilution tools

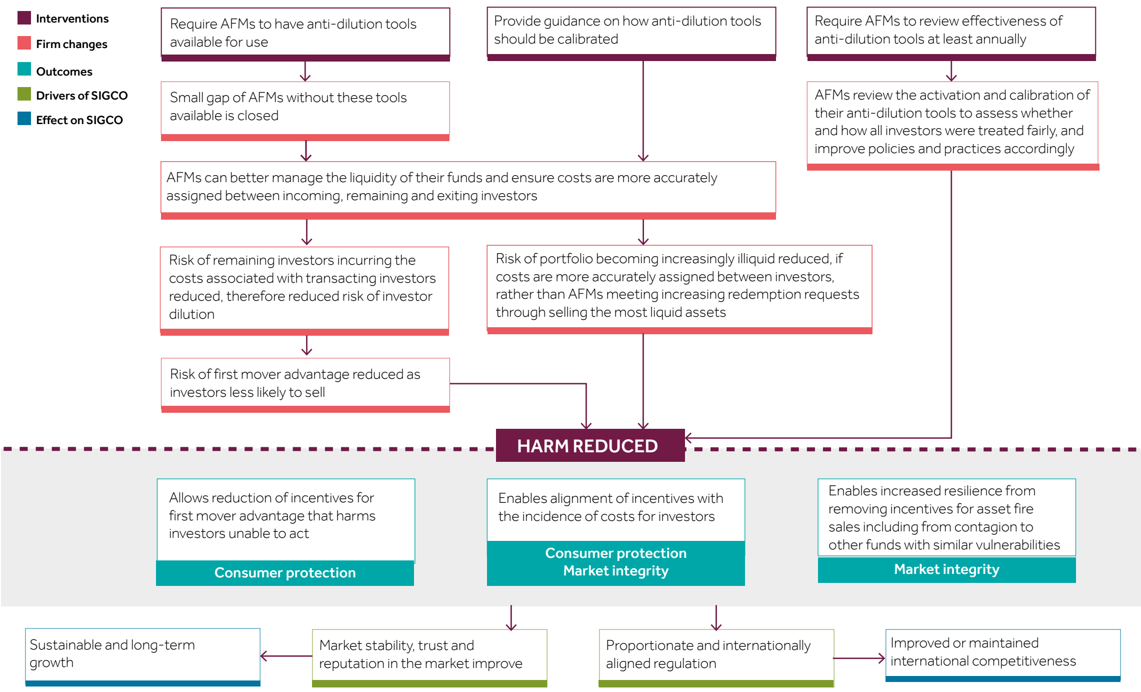
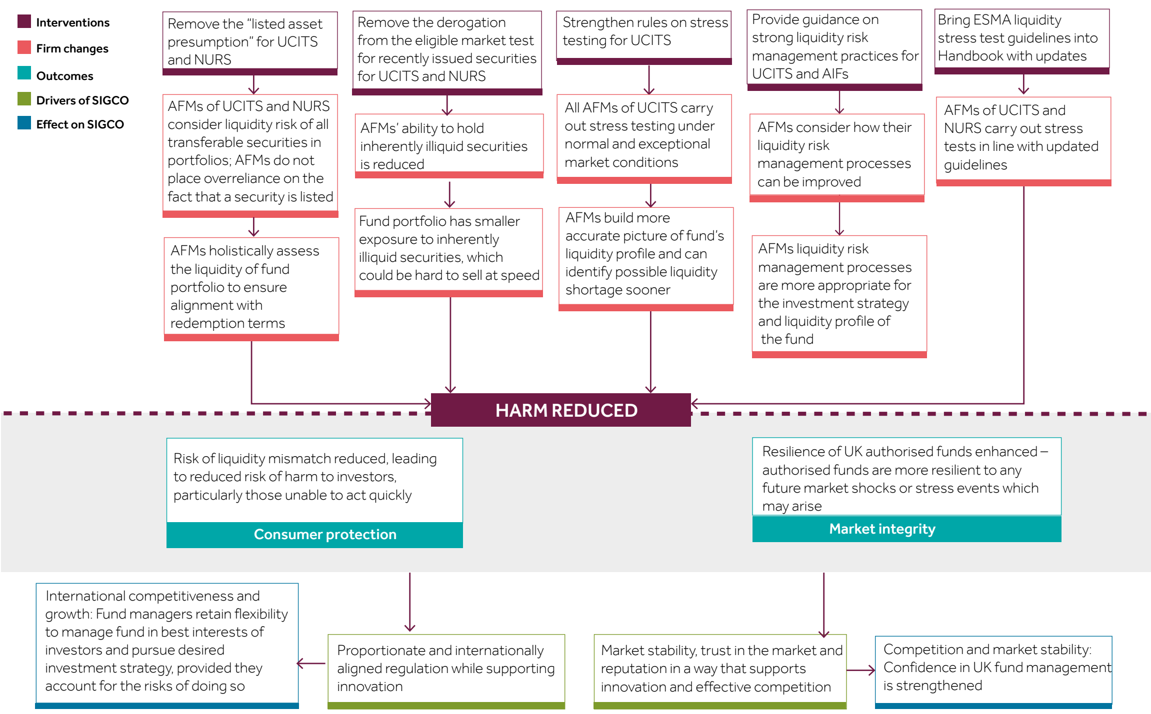


Figure 2: Liquidity management of UCITS schemes and NURS



Baseline and key assumptions

53. The costs and benefits of our proposals must be assessed against a baseline. In this section we discuss our assumptions for the baseline. We also explain the key assumptions we made when analysing the costs and benefits of our proposals.

Baseline

54. Without our interventions, we consider AFMs would continue to use anti-dilution tools in the way which they currently do. The results of the 2020 joint survey with the Bank of England on liquidity management in open-ended funds identified multiple areas for improvement in how these tools are calibrated and deployed (as set out in chapter 3). We consider it unlikely that the small number of AFMs which do not have anti-dilution tools for the funds which they manage would choose to make them available unless required to do so.

55. While we consider the existing rules provide for a high standard of liquidity management by AFMs of UCITS schemes and NURS, we believe some AFMs may be unlikely to proactively consider whether they can improve their liquidity management practices in the absence of our amended rules and new guidance.

Data

56. Based on the results of the 2020 joint survey with the Bank of England on liquidity management in UK open-ended funds, our understanding is the majority of AFMs manage authorised funds which are either dual-priced, or single-priced with the ability to make a dilution levy or dilution adjustment. We have used these survey results to estimate how many AFMs would need to put these tools in place for the first time.

57. While the availability of anti-dilution tools must be disclosed in a fund's prospectus, the current reporting we receive from AFMs does not require them to state whether they have these tools available or make use of them.

58. Given that the 2020 Bank-FCA survey is the most detailed study we have to date on the availability and use of anti-dilution tools, we have chosen to use the estimate derived from these results – 8% of AFMs managing a fund do not have anti-dilution tools available. Widespread use of anti-dilution tools is further supported by an Investment Association statement in an October 2022 publication called 'Enhancing Fund Pricing' that stated: 'Swing pricing is the dominant approach in the UK with over 85% of funds under management being subject to either swing pricing or dual pricing'. We consider the Bank-FCA survey estimate is reasonable as it includes additional anti-dilution tools such as dilution levy among others not captured in the IA estimate of anti-dilution tool availability.

59. We have also carried out a random sampling check across a variety of fund sectors to determine whether 8% of AFMs managing a fund without anti-dilution tools available is a reasonable reflection of the current market. Our sampling shows a much lower number (about 2%). However, we intend to retain the assumption that 8% AFMs managing a fund without anti-dilution tools as these funds might all share unique characteristics and so in that case random sampling might not represent a good estimate of the true number. Based on this we believe our total costs estimates for AFMs managing funds with no anti-dilution tool are likely to be overestimates.

60. We have chosen to use the number of active AFMs (94), excluding those that only manage an LTAF, QIS or an MMF that is not a UCITS scheme or a NURS, for our cost estimation as we believe this better reflects the current market. This means we would expect 8 AFMs to need to put in place anti-dilution tools for the first time, while all active AFMs (regardless of whether the fund(s) they operate are single-priced or dual-priced) would need to consider the guidance on calibration and governance, and introduce an annual review process, where this does not already exist.

Key assumptions

61. We assume that AFMs without anti-dilution tools have a similar size distribution to other AFMs – this leads us to assume 1 large, 4 medium and 3 small AFMs do not have anti-dilution tools. Apart from familiarisation costs, we have not included inactive AFMs in these calculations (those which do not currently manage an active authorised fund) as no cost would be incurred by those AFMs to comply with the amended rules. If those inactive AFMs were to become active in future, they would need to comply with the amended rules, however we do not consider that these would be considered a significant burden, and would be the same for any new firm entering the market.

Fund distributors

62. To some extent, fund distributors might also be affected by the requirement for AFMs to have anti-dilution tools in place given that some small system updates may be needed to reflect the introduction of the tools by these AFMs. However, we consider the impact should be small given that they will already accommodate the use of such tools for other AFMs and so should not need to put any new processes in place.

Depositories' costs

63. Under COLL 6.6.4R a depositary must take reasonable care to ensure the AFM considers whether or not to exercise the power provided by COLL 6.3.8R (Dilution) and, if applicable, the rate or amount of any dilution levy or dilution adjustment that is imposed. However, the depositary has no duty in respect of the AFM's exercise of the discretion to activate these tools. We do not propose to place any new requirement on the depositary, although there may be a small increase in costs that we have factored into our estimates, predominantly in terms of familiarisation.

Changes to assessing and managing liquidity

64. We do not consider our interventions represent fundamental changes to the way in which AFMs assess and manage the liquidity of their funds. Some AFMs of UCITS schemes and NURS may decide that they need to make only relatively small changes to their current practices, while others may decide that they are already compliant.

65. However, all AFMs of UCITS schemes and NURS will need to familiarise themselves with the amended rules, review their internal procedures and update these where appropriate. Given that the draft instrument brings the removal of the derogation from the eligible market test for recently issued securities into effect after one year (see paragraph 4.20 of the CP), AFMs would not need to sell such securities in order to comply with the amended rule.

MiFID investment manager costs

66. Where the AFM delegates the portfolio management function to a MiFID investment manager, the latter will also incur costs in terms of familiarisation and making small changes to its internal systems and policies. That is because in this scenario it is the MiFID investment manager which is responsible for the day-to-day decisions on what assets to buy, hold and sell in order to maintain an appropriate liquidity profile.

The wider fund distribution system

67. We do not consider the wider fund distribution system should be affected by these amended rules and new guidance on UCITS schemes and NURS liquidity risk management.

AFM fund portfolios

68. We do not expect AFMs should need to make any significant changes to their funds' portfolios, beyond what they already do as part of the day-to-day management of their fund in order to meet subscription and redemption requests and respond to market developments. That is because we are placing an emphasis on responsible ongoing liquidity management of a fund, rather than prohibiting certain investment strategies or asset types. Further, under the existing framework, an AFM of an UCITS scheme or a NURS already must provide for a prudent spread of risk and ensure the liquidity profile of the fund is consistent with the redemption terms.

Investor behaviour

69. We make the following assumptions about investor behaviour:

- Our proposals do not require investors to switch or sell funds. We do not consider the requirement for AFMs to have anti-dilution tools available for use would lead an investor to exit a fund, given that under our proposals all AFMs would need to have these tools available.
- Further, our interventions on liquidity risk management for UCITS schemes and NURS should not lead to any changes that are noticeable by the investors, with any changes to the way in which AFMs manage the liquidity of the fund happening 'behind the scenes'. While we recognise changes to the portfolio could mean there are changes in returns which are noticeable by investors, we do not expect AFMs should need to make any material changes to the portfolios of the funds they manage in response to our interventions.

Cost estimates

70. We rely on our standard cost model (SCM) for cost estimates in the CBA, including assumptions to categorise affected firms by size. The SCM categorises all regulated firms as large, medium, or small using data from annual FCA fee blocks. See our Statement of Policy on CBAs for further information.

71. We use standard assumptions from our Statement of Policy on CBAs:

- We use the standard appraisal period of 10 years.
- We assume 100% compliance.
- We apply a discount rate of 3.5% to determine the present value of the stream of costs and benefits we expect to occur in future years.
- All values are in 2025 prices.

72. Additional assumptions are explained in the relevant sections.

Summary of Impacts

73. Our proposals are expected to bring the following benefits:

- Reducing the probability of individuals' financial loss
- Efficient distribution of costs
- Increased orderly markets
- Improving the resilience of UK funds

74. We have not quantified the benefits of our proposals. That said, we think there is a good argument that our proposals are net beneficial. The benefits of our proposals will be dependent on different factors, including funds' investment strategy and portfolio, how robust their liquidity risk management practices are, and type of investors. The outcome is also influenced by the frequency and severity of stress events, which are inherently unpredictable. Even if we could predict these events, it would still be challenging to predict how markets would be affected by our proposals and therefore to estimate benefits. We have undertaken an illustrative break-even analysis for our specific proposals to require AFMs to make anti-dilution tools available and we have found these proposals to be net beneficial for outflows above 20.6% of funds' Net Asset Value (NAV). This is likely to be the case over the 10-year appraisal period. For instance, 6.3% of funds had at least one occasion of experiencing a monthly outflow greater than 20.6% during last 12 months and 16.5% percent of all funds had an aggregate outflow of at least 20.6% of NAV over this period.[1]

75. We consider that the costs of our proposals are relatively small and largely incurred by those firms which do not already have effectively calibrated anti-dilution tools available, or which need to improve their liquidity management to meet our strengthened rules and guidance. We consider that the changes firms make in response to our proposals will bring benefits to the mitigation of stress events that should significantly outweigh the costs. As such, we consider our proposal proportionate and justified to deliver our consumer protection and market integrity objectives.

1 Source: Morningstar – staff calculation.

76. We estimate the present value cost of our proposals over a 10-year appraisal period is approximately £13.74m. These costs are mainly due to familiarisation and compliance, with additional costs arising from IT changes, project management, and updates to sales processes and documentation. These costs will apply to AFMs, delegate MiFID managers, investment platforms and depositaries.

77. We are not proposing to change our supervision approach, nor would reporting requirements change.

78. Table 3 presents a summary of these benefits and costs and the total one-off and ongoing costs to all affected groups.

Table 3 – Summary table of benefits and costs

	Benefits (£)		Costs (£)	
Cost/Benefit type	One off	Ongoing	One off	Ongoing
AFMs				
Increased resilience of UK authorised funds		Not quantified		
Reduced risk of liquidity mismatch		Not quantified		
Familiarisation and gap analysis			£0.47m	
IT change			£2.03m	
Regulatory changes			£2.63m	£0.71m (AFMs with no ADT tools only)
Sales process, customer contact and other changes			£0.14m	
Investors / Unitholders				
Reduced probability of financial loss		Not quantified		
Efficient distribution of costs		Not quantified		Not quantified
Delegate MiFID managers				
Familiarisation and gap analysis			£0.50m	
IT change			£0.66m	
Regulatory changes			£0.77m	
Depositaries				
Familiarisation and gap analysis			£0.04m	
IT change			£0.12m	
Regulatory changes			£0.16m	

Cost/Benefit type	Benefits (£)		Costs (£)	
	One off	Ongoing	One off	Ongoing
Investment platforms				
Familiarisation and gap analysis			£0.07m	
IT change			£0.90m	
FCA/wider society (if relevant)			Negligible (not quantified)	Negligible (not quantified)
Total			£8.49m	£0.71m

Table notes: Figures might not add up because of rounding.

79. Table 4 gives a summary of the present value cost and benefits over a 10-year appraisal period. The equivalised annual net direct cost (EANDCB) to business is approximately £1.60m.

Table 4 – Summary of quantified impacts across 10-year appraisal period

	PV Benefits	PV Costs	NPV	Equivalised annual net direct cost to business (EANDCB)
Total impact	Not quantified	**£13.74m**	**-£13.74m**	**£1.60m**
- of which direct		**£13.74m**	**-£13.74m**	**£1.60m**
- of which indirect	-	-	-	-
Key unquantified items to consider	• Reducing the probability of individuals' financial loss (indirect) • Efficient distribution of costs (indirect) • Increased orderly markets (indirect) • Improving the resilience of UK funds (indirect)			

Benefits

80. In this section, we describe the benefits we expect to arise from the implementation of our proposals. The benefits set out here reflect a reduction in harms described in the section on the problem and rationale for our intervention.

81. It is not reasonably practicable to quantify the benefits of our proposals. The impact of our proposals is specific to the type of unitholders, funds' portfolio and investment strategy, and the extent to which their current liquidity risk management is effective. They also depend on the frequency and size of stress events, which are inherently unpredictable.

Even if we could predict these events, it would still be challenging to estimate how markets would be affected by our proposals, and therefore to quantify the benefits.

82. We identify the principal benefits for investors to be:

- **Reduction in the probability of individuals' financial loss.** Strong liquidity management, including the availability of anti-dilution tools, should mean investors are better protected from the risk of financial loss which could arise as a result of either market-wide or firm-specific stress events. Poor liquidity management by one AFM could also have a knock-on impact on investors in funds managed by other AFMs. For example, if an AFM of a stressed fund fire-sells assets, this could amplify the stress by affecting the value of other funds holding similar securities including negatively impacting the investors in those funds.
- Ensuring AFMs have anti-dilution tools available for use, and policies for when and how they should be activated, can also protect investors, particularly retail investors, from a risk of more incremental financial loss in which the value of their investment is slowly diluted over time.
- **Transfer of costs between investors, including fund liquidity benefits.** If anti-dilution tools are used and calibrated effectively, it can lead to the realignment of the incidence of costs to the transacting investors. This therefore means the costs are transferred between investors, with the redeeming investor incurring the costs of exiting. However, the overall costs borne by the fund will be the same, as the costs to redeeming investors are offset by benefits transferred to non-redeeming investors. We consider there is a benefit overall since the transfer of costs internalises the cost of exiting the fund for transacting investors and disincentivises outflows and first-mover advantage that could harm fund liquidity as well as the remaining investors. As such, the transfer of costs between investors are offset by the transfer of benefits between investors but disincentivising investor outflows is an overall benefit to fund liquidity.

83. Although we consider the primary benefits are for consumer protection, we also identify potential secondary benefits for wider financial markets in terms of promoting market integrity. However, given that the majority of AFMs already have anti-dilution tools available for use, and we already have a comprehensive rulebook for liquidity risk management, we consider the wider impacts may be limited.

84. **More orderly markets:** Strong liquidity management practices can support good market discipline by avoiding scenarios in which AFMs need to quickly sell large holdings, often at a discount. This not only prejudices the investors in that fund, but also affects other funds or financial market participants seeking to sell similar securities. Our proposals to enhance liquidity risk management for UCITS schemes and NURS should help to make UK markets function well by promoting resilient and responsible investing, particularly in less liquid markets.

85. **Improving the resilience of UK funds:** By having strong liquidity risk management systems in place, which consider and take account of a variety of different risks which could occur (ranging from isolated company failures which could impact individual fund strategies to wider market events), authorised funds will also be more resilient to any future market shocks or stress events which may arise. Also, as explained in the

2022 Bank of England's paper, analysis has shown there may be lower sensitivity to negative flows for swing-priced funds, with the impact of performance on expected outflows for swing-priced funds being 62%-64% lower than for non-swing-priced funds. The availability and effective use of anti-dilution tools can therefore also support the resilience of open-ended funds.

Break-even analysis

86. To illustrate the benefits of our proposals, we compare fund outflows against the benefits that will need to be realised for the proposed package to be 'net beneficial', given the compliance costs incurred by firms.

87. We will only focus on cases where our proposals aim to make anti-dilution tools available or promote the effective use of anti-dilution tools. We use the findings from Jin et al.(2019) for the purpose of this illustrative case. They find that the negative impact of large outflows on funds' performance is almost zero for funds using anti-dilution tools, providing strong evidence that tools are effective in passing on trading costs to transacting shareholders. The impact of net outflow on funds' performance for those that do not use anti-dilution tools is estimated to be on average -3.52%. However, this negative impact is almost fully eliminated for funds with anti-dilution tools.

88. Our estimate of average total present value cost of our proposals for funds with no anti-dilution tool is £8.66m, which means approximately £1.08m per fund. This means that our proposal will be net beneficial when funds experience a net outflow equivalent to 20.6% of their NAV.

89. We caveat our break-even analysis with the following limitations:

- Our proposals are net beneficial in the event of outflows larger than 20.6% of funds' NAV. Outflows above this level will have larger net benefits. We see that overall, 6.3% of funds had at least one occasion of experiencing a monthly outflow greater than 20.6% of NAV during last 12 months. Furthermore, 16.5% of all funds had an aggregate outflow of at least 20.6% of NAV over this period.
- Our break-even analysis focuses only on the benefits of the proposals to make anti-dilution tools available for AFMs that do not do so at present. Other proposals to improve anti-dilution tool calibration and liquidity management for UCITS schemes and NURS will bring further benefits that are not quantified in this break-even analysis.

Costs

90. There are some costs for firms to implement these proposals. These costs would be a mixture of one-off costs, including familiarisation costs as well as costs associated with changing systems, updating legal documents and contacting affected parties. There will also be ongoing costs associated with reviewing the effectiveness of the AFM's anti-dilution policy and, in some cases, possibly amending the way in which AFMs of UCITS schemes and NURS carry out liquidity assessments.

91. In terms of anti-dilution tools, the largest costs will be borne by those AFMs which do not already have these tools in place. However, the ongoing costs in terms of assessing the effectiveness of calibration through annual reviews will apply to all AFMs, although this process should not differ substantially from the existing procedures AFMs will have in place to ensure pricing remains fair and accurate, and all investors are treated fairly.

92. Given that the majority of AFMs already make use of these tools, there should not be a substantial change for most investors. The effect of the new guidance on calibration and annual reviews should be that an AFM deploys these tools more effectively, by tailoring them to the unique circumstances of the fund. However, an AFM will need to decide when to activate these tools. Given that the circumstances of each fund are unique, we have not calculated how the calibration of anti-dilution tools might differ depending on whether the AFM took into account both explicit and implicit costs or used a more simplistic approach to calculation.

93. Even where an AFM is required to introduce these tools for the first time, the day-to-day impact on the investor should not be significant. That is because the AFM may determine there is minimal dilution risk and the tools do not need to be activated. Although our proposals do not mandate an AFM to activate its anti-dilution tools, the AFM will need to have procedures in place to be able to assess the dilution risk at each valuation point, and be required to apply its chosen mechanism in a timely manner to protect the interests of all unitholders.

94. In terms of UCITS scheme and NURS liquidity risk management, no AFM should need to implement a wholly new process, as an AFM is already required to have an appropriate liquidity risk management process. However, all AFMs will need to familiarise themselves with the new guidelines and in some cases may need to update their internal procedures.

95. We do not consider the new requirements on AFMs of UCITS scheme or NURS should produce any material cost for investors, and nor should they notice any change in the way they interact with the AFM or its delegates. That is because we do not expect AFMs will need to make any material changes to the portfolios of the funds they manage in response to our interventions.

Familiarisation and gap analysis

96. We expect firms will incur costs from familiarising themselves with the changes we are proposing.

97. We expect all AFMs, even those which are currently inactive (they do not manage an active UK authorised fund), would need to familiarise themselves with our proposals. That is because there is the possibility these firms will become active again in future by seeking FCA authorisation of a fund. Familiarisation and gap analysis costs are estimated based on the assumptions of our SCM.

98. Our estimated familiarisation costs take account of the proposals on anti-dilution tools and UCITS schemes and NURS liquidity risk management.

99. There will be around 80 pages of policy documentation with which firms will need to familiarise themselves. Assuming there are 300 words per page and a reading speed of

100 words per minute, it would take around 4 hours to read the policy documentation. It is further assumed that 20 compliance staff at large firms, 5 compliance staff at medium firms and 2 compliance staff at small firms read the document, at an hourly cost of £68, £63 and £52 for large, medium and small firms respectively.

100. We also expect those affected will undertake a legal review of the new requirements against current practices. Again, we use the SCM to estimate these costs. There are around 45 pages of legal text. We assume the regulatory analysis team consists of 4 legal and compliance staff at a large firm, 2 at a medium firm and 1 at a small firm.

101. In total, we expect one-off costs of familiarisation and gap analysis for AFMs to be £0.47m. Table 5 below shows the breakdown of these costs per firm.

Table 5 – Familiarisation and gap analysis costs

Firm size	Number of firms	Average cost per firm (£)	Total costs to firms (£)
Large	13	£13,414	£174,386
Medium	52	£4,050	£210,605
Small	101	£858	£86,624
Total	166	**£2,841**	**£0.47m**

Implementation costs to AFMs

102. Subject to our final rules, firms will need to incur one-off costs to implement the proposed policy changes. To estimate firm compliance costs we use our SCM. While assumptions in the SCM serve as a good approximation for the one-off costs, they do not necessarily reflect the exact details of the changes firms will need to undertake.

IT changes

103. We estimate that for AFMs that do not have the tools in place, the implementation costs will include the expenses associated with putting in place procedures to assess and mitigate dilution risks, as well as to calibrate these tools.

104. We estimate these new requirements would result in IT changes requiring a large firm 1092 person days to set up, a medium firm 312 person days, and a small firm 100 person days. Given the assumptions on daily cost rates in our SCM for different teams involved, we expect that these 8 AFMs will incur the total cost of £1.13m for IT changes.

105. For those AFMs which already have these tools in place we consider the changes required are substantially smaller. These AFMs should not need to implement any fundamentally new processes but may need to update their existing processes where they do not adequately account for the dilution risk within the fund, for example if the current calibration does not consider implicit costs such as market impact. We therefore estimate these changes to be very small, requiring 46 person days for a large firm to implement, 8 person days for a medium firm and 5 person days for a small firm.

Using the assumptions in our SCM on the rate of teams' costs per day, we estimate a total cost of £431,046.

106. In general, we would expect that AFMs already have systems in place which allow them to model the liquidity of a fund's portfolio and how it might evolve under different circumstances and market conditions. However, we have factored into our estimates that AFMs may need to upgrade their systems to be able to carry out systematic liquidity bucketing of their portfolios. We have calculated these as very small changes under our SCM with the same person day assumptions as above for AFMs with anti-dilution tools in place. We estimate the total cost of IT changes to be £457,052.

107. We estimate the total cost of IT changes to AFMs of our proposals to be £2.03m.

Table 6 – IT changes costs

Firm size	Number of firms	Total person days	Average cost per firm (£)	Total costs to firms (£)
Firms without ADT				
Large	1	1,092	£ 493,542	£ 493,542
Medium	4	312	£ 134,858	£ 539,432
Small	3	100	£ 32,179	£ 96,538
Firms with ADT				
Large	12	46	£ 20,564	£ 246,771
Medium	37	8	£ 3,371	£ 124,744
Small	37	5	£ 1,609	£ 59,532
UCITS and NURS liquidity management				
Large	13	46	£ 20,564	£ 267,335
Medium	41	8	£ 3,371	£ 138,229
Small	40	5	£ 1,609	£ 64,359
Total				**£2.03m**

Regulatory Changes

108. We expect that in familiarising themselves and complying with these new requirements AFMs may incur other costs related to putting in place policies and procedures for how they will identify potential or actual instances of dilution, its likely impact on unitholders, and the most appropriate mechanism to use based on the fund's investment strategy, investor base and other unique circumstances. Given that this will mean operational changes are needed to the way in which a fund is operated, we expect that board approval may also need to be sought. AFMs may also need to update their governance processes to take account of the new dilution policies. For AFMs which do not already have these tools available, we consider this would amount to a moderately-sized project considering the scale of the change needed. This project would require 1,080 person days for a large firm, 560 person days for a medium firm and 18 person days for a small firm.

109. Similarly, we expect that, to a lesser degree, AFMs which already have these tools available will incur similar costs in implementing these system changes. Given that such AFMs are already required to have an anti-dilution policy and to keep six years of records of how the dilution adjustment or dilution levy has been calculated, we expect the costs to be minimal. This would require 45 person days for large firms, 14 person days for medium firms and 3 person days for small firms.

110. We have also factored into our calculations that board and executive committee review would be required for all sizes of firm.

111. We also expect that AFMs may incur additional costs of regulatory changes by implementing our proposed changes regarding robust liquidity risk management processes. Given that AFMs will also be implementing the changes required under the anti-dilution proposals, we estimate any additional regulatory changes for AFMs of NURS and UCITS schemes would be small that they can likely be incorporated into any regulatory changes to implement the anti-dilution proposals.

112. We estimate the total cost of regulatory changes would be £2.63m.

Table 7 – Regulatory changes costs

Firm size	Number of firms	Total person days	Average cost per firm (£)	Total costs to firms (£)
Firms without ADT				
Large	1	1,080	£ 478,162	£ 478,162
Medium	4	560	£ 232,618	£ 930,472
Small	3	18	£ 6,362	£ 19,087
Firms with ADT				
Large	12	45	£ 22,157	£ 265,883
Medium	37	14	£ 7,161	£ 264,972
Small	37	3	£ 1,142	£ 42,256
UCITS and NURS liquidity management				
Large	13	45	£ 22,157	£ 288,040
Medium	41	14	£ 7,161	£ 293,618
Small	40	3	£ 1,142	£ 45,682
Total				**£2.63m**

Sales process, customer contact and other changes

113. We expect those firms which do not already have anti-dilution tools in place will incur costs related to sales processes and how they interact with customers. These AFMs will also incur other costs in terms of updating the prospectus, informing investors of the new dilution policy and record-keeping.

114. Under COLL 4.2.5R (18) the AFM is required to set out its choice of tools and its policy for activating these in their prospectus. Also, COLL 4.3.7G explains a change in dilution policy would be likely constitute a 'significant change', of which unitholders would need to be informed.

115. We expect there will be one-off costs in relation to updating the prospectus. Any ongoing costs should be of minimal significance as fund managers would find the most efficient ways of communicating with investors, including through existing communications mechanisms.

116. Firms' review of fund documentation will involve compliance and legal departments and internal sales staff. We estimate each AFM will take approximately 280 hours to review the existing fund documentation across its fund range. To estimate these costs, we use the hourly rate of £61 per hour that we used for compliance staff in large firms. We estimate the cost of updating the prospectus for each AFM would be £17,080 per AFM, and £136,640 in total for those AFMs without dilution tools. AFMs will be given a year to make the necessary updates to the prospectus and therefore in most cases we expect that these changes would be made at the same time as any other regular updates required.

117. We do not consider the proposals for liquidity risk management for UCITS schemes and NURS should require changes to sales processes or customer contact, given that any changes implemented by AFMs would be to their back-office operations. We have therefore not included any such costs in our calculations.

118. We estimate the total cost of changes to AFMs' sales process, customer contact and other changes would be £136,640.

Ongoing costs to AFMs

119. AFMs will be required to conduct an assessment, at least annually, of how decisions to apply their choice of anti-dilution mechanism to the sales and redemptions of units have ensured all unitholders in the scheme were treated fairly, including those unitholders who were dealing in the units of the scheme, and those unitholders who were already invested or remain invested in the scheme.

120. Under COLL 6.6.6R (3), an AFM of a single-priced fund must make and retain for a period of six years a daily record of: (a) how it calculates and estimates dilution; and (b) its policy and method for determining the amount of any dilution levy or dilution adjustment. Where an AFM makes anti-dilution tools available for the first time in respect of a single-priced fund, the maintenance of this record would constitute an ongoing cost for the AFM.

121. For the annual review and additional record keeping, we assume these costs to be 50% of the initial year 1 regulatory change costs amounting to £713,860 for AFMs without anti-dilution tools and minimal for AFMs with anti-dilution tools.

122. We estimate the total ongoing cost for annual review and record keeping to be £713,860.

123. We do not consider that there should be any ongoing costs associated with the proposed changes to UCITS schemes and NURS liquidity risk management systems. That is because we are not proposing to introduce any new ongoing obligation on AFMs, but rather strengthen the existing liquidity risk management systems which they are already required to have in place. While we have accounted for the costs of AFMs familiarising themselves with the amended rules and guidance, and making any adjustments to their internal systems, we do not consider that the cost of ongoing compliance with the COLL framework should be greater than it is at present.

Costs to other market participants

Delegate MiFID managers

124. We do not consider delegate MiFID managers should need to make changes and incur costs from the anti-dilution proposals. However, we expect MiFID managers' day-to-day management of funds means they would need to incur costs from familiarising themselves with the updated rules on UCITS schemes and NURS liquidity risk management. Using our SCM, we estimate familiarisation costs to be £504,244 for 344 delegate managers following the same assumptions as used for the UCITS schemes and NURS liquidity management proposals. Given that the delegate MiFID managers would be responsible for the day-to-day decisions of whether to buy and sell individual assets, we have factored in the same cost assumptions for IT and regulatory change costs as for the AFMs of the UCITS schemes and the NURS. The total costs for 344 MiFID managers for IT changes amount to £656,929, and regulatory changes at £768,706.

125. We estimate a total cost to delegate MiFID managers of £1.93m.

Depositaries

126. There are 14 firms with permissions to act as trustee or depositary of a UK UCITS scheme and act as a trustee or depositary of an authorised AIF.

127. We estimate these firms would incur familiarisation costs of £36,037. We anticipate depositaries may need to make some changes to accommodate the fact that some AFMs will be developing anti-dilution tools for the first time. We have therefore factored into our estimations that very small IT changes are needed, given that they will already have processes in place for other funds, which amount to a total of £126,911. We have also estimated regulatory change costs of £157, 179 to account for any additional changes which depositaries may incur as a result of AFMs implementing the revised rules, for example in some cases they may establish a dedicated project management team to oversee how AFMs respond to and comply with the revised framework. We also anticipate that depositaries may need to update their boards or governance committees.

128. We estimate the total cost of our proposals for depositaries to be £320,127.

Investment platforms

129. Given the role of investment platforms as intermediaries, we anticipate they will incur some costs as a result of the amended anti-dilution rules. These should be small on the basis that the vast majority of AFMs already use anti-dilution tools. There are 44 investment platform firms which we assume to all be large firms. We have therefore estimated there to be familiarisation costs of £71,765. We anticipate the cost of making the necessary IT changes would be a total of £904,827. However, given that investment platforms should not need to put any new systems in place to accommodate for AFMs introducing anti-dilution tools for the first time, we have not estimated any project costs.

130. We estimate the total cost of our proposals for investment platforms to be £976,592.

Wider economic impacts, including on secondary objective

131. The Financial Services and Markets Act (FSMA 2023) gave the FCA a secondary objective to facilitate the international competitiveness of the UK economy (particularly the financial services sector), and its medium to long-term growth, subject to aligning with relevant international standards. Accordingly, we consider our proposals do not make substantial changes for most firms but are intended to have a positive impact on supporting economic growth through enabling investment and by advancing proportionate regulation and effective competition in the interests of consumers as follows:

132. Proportionate regulation and international markets: Our proposals are proportionate to the outcomes they intend to achieve by allowing AFMs to determine the use of anti-dilution tools and refraining from introducing a prescriptive new liquidity classification framework. Our proposals do not unnecessarily add costs in a way that may erode the capital investment into funds that contribute to economic growth. We maintain proportionality internationally by addressing IOSCO recommendations for liquidity management but not exceeding them in a way that may reduce growth and competitiveness in international markets.

133. Trust, reputation: We aim to support growth by improving fund liquidity management to strengthen fund resilience and contribute to more orderly markets in the cases where AFMs do not have adequate measures in place. Fire sales of fund assets and fund closures driven by liquidity pressures and investor redemptions at individual funds can harm investor confidence. Our policies are designed to build investor confidence: investors who exit funds are expected to incur the associated costs rather than leaving them to the remaining investors. Greater investor confidence from these changes encourages further investment in funds with the potential to contribute to economic growth.

134. Innovation and effective competition: Our proposals ensure AFMs are responsible for their funds' liquidity management while enabling them to make decisions best suited to their funds and to pursue innovative opportunities such as investing in small high-growth companies. This flexibility enables competition through innovation in fund management to contribute to capital investment and so support economic growth.

Monitoring and evaluation

135. We expect to see our interventions leading to AFMs better calibrating the price adjustment applied where there is a risk of material dilution and then carrying out ex-post reviews to assess their accuracy. This should mean both incoming and exiting investors pay or receive a more accurate price for their units, while remaining investors are better protected from dilution effects. Our proposals should also lead to improvements in AFMs' liquidity risk management practices, to the benefit of investors and the wider market.

136. We are reviewing fund reporting to improve the data we collect on funds' portfolios and risks, their investor base and how they use anti-dilution tools. This will allow us to build a more accurate picture of funds' liquidity positions, while making reporting obligations proportionate to the benefits of this data. We will consult separately on changes to fund reporting in due course.

137. In the interim, we will monitor how effectively firms implement our amended rules and guidance on anti-dilution tools. This may include supervisory spot checks and outlier analysis, monitoring at the authorisations gateway, or a future survey or multi-firm review. Given that each fund's circumstances will be unique, we will also continue to take a risk-based approach to supervising the liquidity risk management of UCITS schemes and NURS.

Annex 3

Compatibility Statement

Compliance with legal requirements

1. This Annex records the FCA's compliance with a number of legal requirements applicable to the proposals in this CP, including an explanation of the FCA's reasons for concluding that our proposals in this consultation are compatible with certain requirements under the Financial Services and Markets Act 2000 (FSMA).

2. When consulting on new rules, the FCA is required by section 138I(2)(d) FSMA to include an explanation of why it believes making the proposed rules (a) is compatible with its general duty under section 1B(1) FSMA, so far as reasonably possible, to act in a way which is compatible with its strategic objective and advances one or more of its operational objectives, (b) so far as reasonably possible, advances the secondary international competitiveness and growth objective, under section 1B(4A) FSMA, and (c) complies with its general duty under section 1B(5)(a) FSMA to have regard to the regulatory principles in section 3B FSMA. The FCA is also required by s 138K(2) FSMA to state its opinion on whether the proposed rules will have a significantly different impact on mutual societies as opposed to other authorised persons.

3. This Annex also sets out the FCA's view of how the proposed rules are compatible with the duty on the FCA to discharge its general functions (which include rule-making) in a way which promotes effective competition in the interests of consumers (section 1B(4)). This duty applies in so far as promoting competition is compatible with advancing the FCA's consumer protection and/or integrity objectives.

4. In addition, this Annex explains how we have considered the recommendations made by the Treasury under s 1JA FSMA about aspects of the economic policy of His Majesty's Government to which we should have regard in connection with our general duties.

5. Under the Legislative and Regulatory Reform Act 2006 (LRRA) the FCA is subject to requirements to have regard to a number of high-level 'Principles' in the exercise of some of our regulatory functions and to have regard to a 'Regulators' Code' when determining general policies and principles and giving general guidance (but not when exercising other legislative functions like making rules). This Annex sets out how we have complied with requirements under the LRRA.

6. The proposals set out in this consultation paper are intended to advance the FCA's operational objectives of:

- Delivering consumer protection - securing an appropriate degree of protection for consumers.
- Enhancing market integrity – protecting and enhancing the integrity of the UK financial system.

- Building competitive markets – promoting effective competition in the interests of consumers.

7. This consultation aims to strengthen the framework for UK AFMs' liquidity risk management practices in line with IOSCO's May 2025 revised recommendations. The consultation identifies specific areas where we can enhance rules and provide additional guidance to strengthen the existing framework for liquidity risk management, in the interests of consumers and financial markets.

8. Our proposal keeps AFMs responsible for funds' liquidity management, which should enable them to make suitable decisions for funds and pursue innovative opportunities. This could include investment in small, high-growth companies. Access to a wide range of funds offering such investment strategies should help promote effective competition between fund managers in the best interests of investors.

9. Finally, we explain in paragraph 2.37 how our proposals advance the FCA's secondary objective to facilitate the international competitiveness of the UK economy and its medium to long term growth.

10. Paragraphs 2.34 to 2.36 cover how these proposals advance our operational objectives. These include an explanation of how the proposals deliver consumer protection and enhance market integrity.

11. The proposals implement IOSCO recommendations in the UK, without adding further requirements for firms. In this way, the proposals offer regulatory predictability which can advance growth and international competitiveness through adherence to international best practice. By not adding requirements beyond IOSCO's recommendations, we aim to support the growth of the UK economy by keeping costs low for firms and investors.

12. In preparing the proposals set out in this consultation, we have also had regard to the regulatory principles set out in section 3B FSMA. By not going beyond the guidelines set out by IOSCO in their revised recommendations, we are ensuring that the enhancements to the UK liquidity risk management framework are proportionate, given the already strong liquidity risk management framework in place in the UK.

13. The proposals in this consultation support the FCA's work to implement the recommendations made by the Treasury under s 1JA FSMA. The proposals support the growth mission and embedding of the secondary objective by seeking to implement international best practice recommendations, while retaining the principle that AFMs have responsibility for managing their funds in the best interests of investors. In developing these proposals we have engaged with the Bank of England, the Prudential Regulation Authority and HM Treasury.

The need to use our resources in the most efficient and economic way

14. These proposals represent an efficient and economic use of our resources. We are making targeted interventions which reflect our knowledge of the market and areas for improvement. Going forward, we will continue to take a risk-based approach to supervision.

The principle that a burden or restriction should be proportionate to the benefits

15. We have carefully considered the proportionality of our proposals. Our consultation does not propose fundamental changes to the liquidity risk management framework, but does seek to benefit consumers by proposing targeted reforms to improve the liquidity risk management practices of AFMs managing UCITS schemes and NURS.

The need to contribute towards achieving compliance by the Secretary of State with section 1 of the Climate Change Act 2008 (UK net zero emission target) and section 5 of the Environment Act 2021 (environmental targets)

16. In developing these proposals, we have had regard to our duties under these requirements. The outcome of our consideration is set out in paragraphs 2.40 and 2.41.

The general principle that consumers should take responsibility for their decisions

17. While, under our proposals, AFMs will be required to have anti-dilution policies and procedures in place, and disclose this information in the prospectus, it will remain the responsibility of consumers to decide which fund best suits their investment objectives.

The responsibilities of senior management

18. This consultation makes clear that we do not expect AFMs to make significant changes in their approach to liquidity risk management.

19. Therefore, we do not expect our proposals to impose new significant responsibilities on senior managers. Senior managers should continue to exercise their duties in line with the approach set out by the FCA across regulated firms under the Senior Managers and Certification Regime (SM&CR).

The desirability of recognising differences in the nature of, and objectives of, businesses carried on by different persons including mutual societies and other kinds of business organisation

20. Our proposals recognise the differences in the nature and objectives of the businesses the FCA regulates and do not adversely impact a subset of businesses. Our proposals will not impact mutual societies.

The desirability of publishing information relating to persons subject to requirements imposed under FSMA, or requiring them to publish information

21. Our proposals do not involve publishing information relating to authorised persons. We propose amendments to the rules on what an AFM of a UCITS scheme or NURS must include in the prospectus, but do not propose any new disclosure requirement.

The principle that we should exercise of our functions as transparently as possible

22. We have acted transparently in developing these proposals. IOSCO's publication of the revised recommendations in May 2025 already gave a clear indication of the topic areas that national regulators, including the FCA, should have regard to when developing enhancements to liquidity risk management practices. In our Regulatory Initiatives Grid, published in April 2025, we committed to consulting on proposals implementing the IOSCO guidelines.

23. By consulting now, we are giving firms time to consider the specifics of our proposals and to submit a response voicing comments or concerns on our intentions.

24. In formulating these proposals, we have had regard to the importance of taking action intended to minimise the extent to which it is possible for a business carried on (i) by an authorised person or a recognised investment exchange, or (ii) in contravention of the general prohibition, to be used for a purpose connected with a financial crime. We consider that this principle is not relevant to these proposals but will continue to keep this under review.

Expected effect on mutual societies

25. The FCA does not expect the proposals in this paper to have an impact on mutual societies.

Equality and diversity

26. We are required under the Equality Act 2010 in exercising our functions to 'have due regard' to the need to eliminate discrimination, harassment, victimisation and any other conduct prohibited by or under the Act, advance equality of opportunity between persons who share a relevant protected characteristic and those who do not, to and to foster good relations between people who share a protected characteristic and those who do not.

27. In paragraph 2.42, we set out how we have considered this requirement when developing our proposals.

Legislative and Regulatory Reform Act 2006 (LRRA)

28. We have had regard to the principles in the LRRA and Regulators' Code (together the 'Principles') for the parts of the proposals that consist of general policies, principles or guidance. We consider that these parts of our proposals are compliant with the five LRRA principles - that regulatory activities should be carried out in a way which is transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed.

- Transparent – We are consulting on our policy proposals with industry. We are being transparent and providing a simple and straightforward way to engage with the regulated community.
- Accountable – We are consulting on proposals and may publish final rules after considering all feedback received. We are acting within our statutory powers, rules and processes.

- Proportionate – We recognise that firms may be required to make changes to how they carry out their business and have provided for an implementation period to give them time to do so. The CBA sets out further details on the costs and benefits of our proposals.
- Consistent – We want to provide for a level-playing field for UCITS schemes and NURS and so our proposals are not targeted at funds with specific strategies or investment policies. Rather the emphasis is placed on the AFM assessing and accounting for the liquidity implications of its investment decisions.
- Targeted – Our proposals should enhance our ability to provide targeted firm engagement and consider how to best deploy our resources.
- Regulators' Code – Our proposals are carried out in a way that supports firms to comply and grow through our consideration of their feedback via the CP and refining our proposals where necessary. Our CP, CBA, draft instrument, accompanying annexes, public communications and communications with firms are intended to be provided in a simple, straightforward, transparent and clear way to help firms meet their responsibilities.

Annex 4

Abbreviations used in this CP

Abbreviation	Description
AIF	Alternative Investment Fund
AIFM	Alternative Investment Fund Manager
AIFMD	Alternative Investment Fund Managers Directive
AFM	Authorised Fund Manager
CESR	Committee of European Securities Regulators
COLL	Collective Investment Schemes sourcebook
CP	Consultation paper
ESG	Environmental, social and governance
ESMA	European Securities and Markets Authority
ETF	Exchange-Traded Fund
FPC	Financial Policy Committee
FSB	Financial Stability Board
FUND	Investment Funds sourcebook
IA	Investment Association
IPO	Initial Public Offering
ISA	Individual Savings Account
IOSCO	International Organization for Securities Commissions
LTAF	Long-term Asset Fund
MiFID	Markets in Financial Instruments Directive
MMF	Money-Market Fund
NURS	Non-UCITS Retail Scheme
OEIC	Open-Ended Investment Company
QIS	Qualified Investor Scheme
RIE	Recognised Investment Exchange
SIPP	Self-Invested Personal Pension
UCITS	Undertakings for Collective Investment in Transferable Securities
WEIF	Woodford Equity Income Fund
WIM	Woodford Investment Management

Appendix 5

Draft Handbook text

COLLECTIVE INVESTMENT SCHEMES SOURCEBOOK (LIQUIDITY MANAGEMENT) INSTRUMENT 2026

Powers exercised

A. The Financial Conduct Authority ("the FCA") makes this instrument in the exercise of the powers and related provisions in or under:

(1) the following sections of the Financial Services and Markets Act 2000 ("the Act"):

(a) section 137A (The FCA's general rules);
(b) section 137T (General supplementary powers);
(c) section 139A (Power of the FCA to give guidance);
(d) section 247 (Trust scheme rules);
(e) section 248 (Scheme particulars rules);
(f) section 261I (Contractual scheme rules); and
(g) section 261J (Contractual scheme particulars rules);

(2) regulation 6(1) of the Open-Ended Investment Companies Regulations 2001 (SI 2001/1228); and

(3) the other rule and guidance making powers listed in Schedule 4 (Powers exercised) to the General Provisions of the FCA's Handbook.

B. The rule-making provisions listed above are specified for the purposes of section 138G(2) (Rule-making instruments) of the Act.

Commencement

C. This instrument comes into force on [*date*].

Amendments to the Handbook

D. The modules of the FCA's Handbook of rules and guidance listed in column (1) below are amended in accordance with the Annexes to this instrument listed in column (2) below[1].

(1)	(2)
Glossary of definitions	Annex A
Collective Investment Schemes sourcebook (COLL)	Annex B
Investment Funds sourcebook (FUND)	Annex C

Notes

[1] The material in this instrument is in part adapted from the European Institutions © European Union, 1998-2025 and re-used and adapted under the terms of the Commission Decision 2011/833/EU

E. In the annexes to this instrument, the notes (indicated by "**Note**:" and "*Editor's note*:") are included for the convenience of readers, but do not form part of the legislative text.

Citation

F. This instrument may be cited as the Collective Investment Schemes Sourcebook (Liquidity Management) Instrument 2026.

By order of the Board
[*date*]

Annex A

Amendments to the Glossary of definitions

In this Annex, underlining indicates new text and striking through indicates deleted text.

Amend the following definition as follows.

dilution	(in *COLL*) the amount of *dealing* costs incurred, or expected to be incurred, by or for the account of ~~a *single-priced authorised fund*~~ an *authorised fund* to the extent that these costs may reasonably be expected to result, or have resulted, from the acquisition or disposal of *investments* by or for the account of the ~~*single-priced authorised fund*~~ *authorised fund* as a consequence (whether or not immediate) of the increase or decrease in the cash resources of the ~~*single-priced authorised fund*~~ *authorised fund* resulting from the *issue* or *cancellation* of *units* over a period~~;~~. ~~for~~ For the purposes of this definition, *dealing* costs include both the costs of *dealing* in an *investment*, professional fees incurred, or expected to be incurred, in relation to the acquisition or disposal of an immovable and, where there is a spread between the *buying* and selling prices of the *investment*, the indirect cost resulting from the differences between those prices.

Annex B

Amendments to the Collective Investment Schemes sourcebook (COLL)

In this Annex, underlining indicates new text and striking through indicates deleted text, unless otherwise stated.

4 Investor Relations

…

4.2 Pre-sale notifications

…

Table: contents of the prospectus

4.2.5 R This table belongs to *COLL* 4.2.2R (Publishing the prospectus).

…			
Dilution			
18	~~In the case of a *single-priced* *authorised fund*, details~~ Details of what is meant by *dilution* including:		
	(a)	a statement explaining:	
		…	
		(ii)	~~which of the policies the *authorised fund manager* is adopting under *COLL* 6.3.8R(1) (Dilution)~~ the *authorised fund manager's* policies and procedures under *COLL* 6.3.7AR or, with respect to a *regulated money market fund*, its policies for the purposes of *COLL* 6.3.8R(1) and *COLL* 6.3.8R(1A) (Dilution), together with an explanation of how ~~this policy~~ these policies and procedures may affect the future growth of the *authorised fund*; ~~and~~
	(b)	~~if the *authorised fund manager* may require a *dilution levy* or make a *dilution adjustment*, a statement of~~ in relation to a *single-priced authorised fund*, the statement at (1) must include the following:	
		…	
…			

…

5 Investment and borrowing powers

5.1 Introduction

…

Purpose

5.1.2 G (1) …

(1A) The *rules* relating to the spreading of risk aim to protect investors from losses that might arise if, for example, a *scheme* is overly concentrated in a small number of investments, or cannot raise enough liquidity to meet *redemption* demands on a timely basis, or has excessive exposure to a counterparty that can no longer meet its obligations to the *scheme*.

…

…

5.2 General investment powers and limits for UCITS schemes

…

Investment in transferable securities

5.2.7A R (1) A *UCITS scheme* may invest in a *transferable security* only to the extent that the *transferable security* fulfils the following criteria at the time of its acquisition and for as long as it comprises part of the *scheme property*:

…

(2) Unless there is information available to the *authorised fund manager* that would lead to a different determination, a *transferable security* which is admitted to or *dealt* in on an *eligible market* shall be presumed:

(a) ~~not to compromise the ability of the *authorised fund manager* to comply with its obligation to *redeem units* at the request of any qualifying *unitholder*; and~~ [deleted]

…

…

5.2.7B G (1) Where information is available to the *authorised fund manager* ~~considers~~ that the liquidity or negotiability of a *transferable security* might compromise the ability of the *authorised fund manager* to comply with its obligation to *redeem units* at the request of any qualifying *unitholder*, it should assess the liquidity risk of that *transferable security* in accordance with ~~*CESR's UCITS eligible assets guidelines* with respect to article 2(1) of the *UCITS eligible assets Directive*~~ the stress testing required under *COLL* 6.12.11R (Measurement and management of risk) and *COLL* 6 Annex 5 (Guidance notes on liquidity stress testing in UCITS schemes and non-UCITS retail schemes)).

(2) When assessing whether the liquidity of a *transferable security* might compromise the *authorised fund manager's* ability to meet *redemption* requests for the purpose of *COLL* 5.2.7AR(1)(b), the *authorised fund* manager should consider:

(a) the quality of secondary market activity in the *transferable security*, in terms of:

(i) the volume of transactions in relation to the trading of that *transferable security* over a reasonable period of time, having regard to the nature of the *transferable security*; and

(ii) the number and quality of intermediaries and *market makers* with respect to the trading of that *transferable security*;

(b) how the *scheme's* holding of, or proposed transaction in, a *transferable security* that it might need to trade in the event of significant *redemptions* or subscriptions, compares to the average daily volume of trades in that *transferable security*;

(c) the opportunities available to buy or sell the *transferable security* and the time it may take to do so; and

(d) the proportion of the value of the *scheme property* that the *transferable security* represents.

(3) An *authorised fund manager* may choose to inform its assessment of the relative liquidity and negotiability of a *transferable security* by reference to analysis of sales and purchase figures by an independent third party.

…

Transferable securities and money-market instruments generally to be admitted to or dealt in on an eligible market

5.2.8 R …

(3) Subject to (5), *transferable securities* and *approved money-market instruments* held within a *UCITS scheme* must be:

…

(d) for an *approved money-market instrument* not admitted to or *dealt* in on an *eligible* market, within *COLL* 5.2.10AR (1)~~; or~~.

(e) ~~recently issued *transferable securities*, provided that:~~

~~(i) the terms of issue include an undertaking that application will be made to be admitted to an *eligible* market; and~~

~~(ii) such admission is secured within a year of issue.~~ [deleted]

…

[**Note**: article 50(1)(a)-~~(d)~~ (c) and (h) and (2)(a) of the *UCITS Directive* and article 3(1) of the *UCITS eligible assets Directive*]

…

Eligible markets regime: purpose

5.2.9 G …

(2) …

(3) In relation to *COLL* 5.2.8R(4), recently issued *transferable securities* that are not yet admitted to trading or *dealt* in on an *eligible* market fall within the 10% limit.

…

Eligible markets: requirements

…

5.2.10A R …

5.2.10AA G In considering whether a market is adequately liquid for the purposes of *COLL* 5.2.10R(3)(e), the *authorised fund manager* should consider how the factors set out in *COLL* 5.2.7BG(2) and (3) apply generically to the types of *scheme property* in which it intends to invest through that market.

…

Permitted transactions (derivatives and forwards)

5.2.20 R …

(2) The underlying of a transaction in a *derivative* must consist of any one or more of the following to which the scheme is *dedicated*:

(a) *transferable securities* permitted under *COLL* 5.2.8R(3)(a) to (c) ~~and *COLL* 5.2.8R(3)(e)~~;

…

…

…

5.6 Investment powers and borrowing limits for non-UCITS retail schemes

…

Eligibility of transferable securities and money-market instruments for investment by a non-UCITS retail scheme

5.6.5 R *Transferable securities* and *money-market instruments* held within a *non-UCITS retail scheme* must:

(1) subject to *COLL* 5.6.5-AR:

…

(b) ~~be recently issued *transferable securities* which satisfy the requirements for investment by a *UCITS scheme* set out in *COLL* 5.2.8 R (3)(e); or~~ <u>[deleted]</u>

…

…

…

6 Operating duties and responsibilities

…

6.3 Valuation and pricing

Application

6.3.1 R …

(3) The following *rules* and *guidance* do not apply to an *authorised fund manager*, a *depositary*, an *ICVC*, or any other ~~directo<u>r</u>~~ <u>*director*</u> of an *ICVC* where the *authorised fund* is a *regulated money market fund*:

…

(d) *COLL* 6.3.5R; ~~and~~

(e) *COLL* 6.3.5AR to *COLL* 6.3.5CG~~.~~<u>;</u>

(f) *COLL* 6.3.7AR;

(g) *COLL* 6.3.7BG to *COLL* 6.3.7DG;

(h) *COLL* 6.3.8BR; and

(i) *COLL* 6.3.8CG.

…

Purpose

6.3.2 G …

(2) An *authorised fund manager* is responsible for valuing the *scheme property* of the *authorised fund* it manages and for calculating the price of *units* in the *authorised fund*. This section protects *clients* by:

…

(b) ~~allowing~~ requiring the *authorised fund manager* to take steps to mitigate the effects of ~~any~~ *dilution* (reduction) in the value of the *scheme property* caused by buying and selling underlying investments as a result of the *issue* or *cancellation* of *units*; and

…

…

…

Sale and redemption price parameters for dual-priced authorised funds

6.3.5B R …

6.3.5BA G An *authorised fund manager* should apply *COLL* 6.3.5BR so as to ensure fair treatment between *unitholders* who are *dealing* in *units* and *unitholders* who were already invested or remain invested in the *scheme.*

…

Dilution

6.3.7A R (1) An *authorised fund manager* must put in place policies and procedures which set out:

(a) how the *authorised fund manager* will identify instances, or potential instances, of *dilution* affecting the value of the *scheme property*;

(b) how, in such instances, the *authorised fund manager* will assess, at each *valuation point*, the impact, or likely impact, of such *dilution* on the *unitholders* in the *scheme*; and

(c) the anti-*dilution* mechanism that the *authorised fund manager* will use when necessary to protect the interests of *unitholders* in the *scheme* from *dilution* affecting the value of the *scheme property* (see (2)).

(2) The mechanism in (1)(c) must be:

(a) in the case of a *single-priced authorised fund*, a *dilution levy* or a *dilution adjustment*; or

(b) in the case of a *dual-priced authorised fund*, the *authorised fund manager's* ability to set the *buying* and *selling prices* of a *unit*.

(3) In relation to a *single-priced authorised fund*, the policies and procedures at (1) must include:

(a) the *authorised fund manager's* policy on:

(i) when to require a *dilution levy* and its policy on *large deals* (including what is meant by *large deals*); or

(ii) when to make a *dilution adjustment*;

(b) how the *authorised fund manager* calculates the estimated rate or amount of any *dilution levy* or *dilution adjustment* based either on historical data or future projections; and

(c) when the *authorised fund manager* may require a *dilution levy* or make a *dilution adjustment* and the basis (historical or projected) on which the statement is made.

(4) An *authorised fund manager* must apply the policies and procedures referred to in (1) and (3) as appropriate to the circumstances and in a timely manner.

6.3.7B G (1) An *authorised fund manager* should ensure that the policies and procedures for the *authorised fund* enable the anti-*dilution* mechanism in *COLL* 6.3.7AR(1)(c) to be applied at every *valuation point*.

(2) However, the mechanism need not be applied when the *authorised fund manager* has assessed reasonably that the *dilution* affecting the value of the *scheme property*, or the potential for such *dilution*, does not pose a material risk to *unitholders*. For example, cash outflows due to the *redemption* of *units* may be offset against cash inflows from the purchase of *units*.

6.3.7C	G	(1)	An *authorised fund manager's* policies and procedures should also provide for the appropriate calibration of the mechanism.
		(2)	An *authorised fund manager* should take account of the explicit and implicit liquidity costs associated with a transaction, or potential transaction, calculated on the basis of a pro-rata apportionment of the *scheme property* across all *unitholders*, where any anti-*dilution* mechanism at *COLL* 6.3.7AR(1)(c), should reflect a fair estimate of the true cost to the *scheme*.
		(3)	The implicit liquidity costs at (2) include an appropriate estimate, by reference to previous transactions or relevant market data and models, of the likely impact on the price of a *transferable security* in circumstances where the *authorised fund manager* is required to sell a significant quantity of that *transferable security* in order to meet one or more *redemption* requests.
6.3.7D	G	An *authorised fund manager* should take into account the *guidance* on liquidity risk management practices set out in *COLL* 6 Annex 4.	
6.3.8	R	…	
6.3.8A	G	An *authorised fund manager* should apply *COLL* 6.3.8R(2) so as to ensure fair treatment between *unitholders* who are *dealing* in *units* and *unitholders* who were already invested or remain invested in the *scheme*.	
6.3.8B	R	An *authorised fund manager* must conduct a retrospective assessment at least annually of how decisions to apply, or refrain from applying, the mechanism at *COLL* 6.3.7AR(1)(c) to the *sales* and *redemptions* of *units* have ensured that all *unitholders* in the *scheme* have been treated fairly, including those *unitholders* who were *dealing* in the *units* of the *scheme*, and those *unitholders* who were already invested or remained invested in the *scheme*.	
6.3.8C	G	An assessment under *COLL* 6.3.8BR should review:	
		(1)	the choice of mechanism that was employed, where more than one could have been used;
		(2)	the calibration of the mechanism (or mechanisms, where more than one was used); and
		(3)	whether, during the period being assessed, the frequency in applying the mechanism was appropriate, having regard to the particular characteristics of the *scheme property* and the information available to the *authorised fund manager* with respect to the investor profile of the *scheme*.

…

6.6 Powers and duties of the scheme, the authorised fund manager, and the depositary

…

Functions of the authorised fund manager

6.6.3 R …

(4) …

(5) The *authorised fund manager* must identify, manage and monitor conflicts of interest arising, or which may foreseeably arise, between:

(a) *unitholders* who wish to redeem their *units* and *unitholders* who wish to retain their *units*; and

(b) the *authorised fund manager's* incentive to invest in less liquid assets or illiquid assets (insofar as it is permitted by the *rules* and the *scheme's* investment objective and policy), and its obligations to *redeem units* in accordance with *COLL* 6.2.16R (Sale and redemption).

…

6.12 Risk management policy and risk measurement

…

Measurement and management of risk

…

6.12.11 R …

(2) ~~Where appropriate, the~~ The *authorised fund manager* must conduct stress tests to enable it to assess the *liquidity risk* of the *UCITS* under both normal and exceptional circumstances.

[**Note**: article 40(3) of the *UCITS implementing Directive*]

6.12.11A G An *authorised fund manager* should, in meeting the requirements of *COLL* 6.12.11R, take into account the *guidance* at *COLL* 6, Annex 5 (Guidance notes on liquidity stress testing in UCITS schemes and non-UCITS retail schemes).

…

Insert the following new Annexes, COLL 6 Annex 4 and COLL 6 Annex 5, after COLL 6 Annex 3 (Guidance notes on UK UCITS management company of UCITS schemes: Derivative Use Report (FSA042: UCITS)). All the text is new and is not underlined.

6 Annex 4 **Guidance notes on liquidity risk management**

This Annex belongs to *COLL* 6.3.7DG (Dilution) and *FUND* 3.7.5ABG (Risk management systems).

Purpose

6 Annex 4.1.1 G This Annex provides *guidance* on *rules* in *COLL* relating to the management of liquidity in an *authorised fund*.

6 Annex 4.1.2 G This Annex is also relevant to *FUND* 3.7.5ABG (Risk management systems).

Overview

6 Annex 4.2.1 G When complying with the *rules* and other requirements relating to the liquidity risk management of a *UCITS scheme* or a *non-UCITS retail scheme* that invests primarily in liquid assets, an *authorised fund manager* should apply the underlying principle that it must act in the best interests of *unitholders.*

[**Note**: See *COBS* 2.1.1R (The client's best interest rule) in relation to a *non-UCITS retail scheme* managed by a *small authorised UK AIFM*, *COLL* 6.6A.2R (Duties of AFMs of UCITS schemes to act in the best interests of the scheme and its unitholder) with respect to a *UCITS scheme* and *COBS* 2.1.4R(2) (AIFMs' best interests rules) with respect to a *non-UCITS retail scheme* managed by a *full-scope UK AIFM*. See also, Articles 46 to 49 of the *AIFMD level 2 regulation*]

6 Annex 4.2.2 G (1) An effective liquidity risk management system relies on the liquidity of a *scheme's* portfolio being consistent with its *redemption* policy.

(2) An *authorised fund manager* should take account of (1) and (where applicable) *COLL* 6.12.12R (Measurement and management of risk) or *FUND* 3.6.2R (Alignment of investment strategy, liquidity profile and redemption policy) both at the design stage of a *scheme* and on an ongoing basis, to allow *unitholders* to *redeem* at an accurate price that reflects the value of their investment, ensuring fairness for both *redeeming unitholders* and those remaining in the *scheme*.

6 Annex 4.2.3 G (1) An *authorised fund manager* should decide what is an appropriate *redemption* policy by considering the *scheme's* unique characteristics.

(2) A material exposure to illiquid asset classes – such as real estate, infrastructure, private equity and private debt – within a *scheme* which is daily *dealt,* without applying a notice period or similar

		mechanism, would be likely to mean that the investment strategy, liquidity profile and *redemption* policy are not aligned.	
6 Annex 4.2.4	G	An *authorised fund manager* should be aware that the following *rules* relating to investment powers are particularly important for managing the ongoing liquidity of a *UCITS scheme* and a *non-UCITS retail scheme*:	
		(1)	*COLL* 5.2.3R(1);
		(2)	*COLL* 5.6.3R(1);
		(3)	*COLL* 5.2.7AR(1)(b); and
		(4)	*COLL* 5.6.5AR.
6 Annex 4.2.5	G	Once a *scheme* has been established and has raised sufficient capital to invest in a diversified asset portfolio, the portfolio management function will be responsible for investment decisions as to whether a *scheme* can meet its *redemption* obligations to *unitholders* and, on that basis, should act as the primary safeguard for ensuring liquidity.	
6 Annex 4.2.6	G	(1)	On the basis that the requirement to provide a prudent spread of risk applies to all risks relevant to the *scheme property*, an *authorised fund manager* and, where applicable, a portfolio manager should consider each investment decision in the light of how it will support risk diversification.
		(2)	For example, with respect to (1), an *authorised fund manager* and where applicable, a portfolio manager should consider whether *buying* or *selling* a particular asset is likely to increase the overall proportion of *scheme property* that cannot be sold in good time under normal market conditions to meet the requirements of *COLL* 6.2.16R (Sale and redemption).
6 Annex 4.2.7	G	(1)	For the majority of *UCITS schemes* and *non-UCITS retail schemes*, the liquidity of *transferable securities* is critical since they normally comprise the greater part of *scheme property*.
		(2)	In an actively-managed *scheme*, the due diligence process applied to a prospective new investment in a *transferable security* should include careful consideration of its market liquidity and how that is likely to affect the portfolio as a whole.
		(3)	In relation to (2), this includes consideration of the degree of exposure the *authorised fund manager* is taking to the overall issuance of the *transferable security*, which may be significant in the case of some small-cap *transferable securities*.
6 Annex 4.2.8	G	(1)	All the other *rules* in *COLL* 5 (Investment and borrowing powers) not specifically referred to should, in so far as they relate to the

liquidity of the *scheme*, be interpreted with regard to the principles set out in this Annex.

(2) For example, with respect to (1):

(a) an *authorised fund manager's* consideration of the liquidity of an *eligible market* should not override its judgement as to whether any particular asset traded on that market is adequately liquid; and

(b) in applying the requirements in *COLL* 5.2.11R (Spread: general) in relation to investment spread, an *authorised fund manager* should not assume that an asset is adequately liquid simply because its value does not exceed a percentage of the value of *scheme property* specified in the *rule*.

An authorised fund manager's liquidity risk management system

6 Annex 4.3.1 G (1) An *authorised fund manager* should take account of all relevant factors which could affect the *scheme's* liquidity when designing an effective liquidity risk management system.

(2) Effective liquidity management practices should provide an *authorised fund manager* with a holistic view of the risks that may arise in different market conditions and should facilitate its ability to identify an emerging liquidity shortage before it occurs.

6 Annex 4.3.2 G (1) The key features of an effective liquidity risk management system include those relating to liquidity bucketing (see (2)) and setting thresholds between the liquidity buckets (see (3)).

(2)

(a) An *authorised fund manager* should employ a systematic and robust liquidity bucketing system which considers, at a minimum:

(i) market depth and turnover;

(ii) the time it would take to sell an asset or a portion of it under different market conditions;

(iii) the likely market impact of large transactions;

(iv) operational features and potential frictions; and

(v) valuation certainty.

(b) The *authorised fund manager* should regularly assess the liquidity of a portfolio and review its liquidity bucketing allocations, including in response to any outcomes of its stress testing.

[**Note**: See *COLL* 6 Annex 4.8.1 to *COLL* 6 Annex 4.8.3]

(c) An *authorised fund manager* should take account of the time it would take to sell *transferable securities* in the different buckets without a price discount and how the price would be affected if a sale is required within a shorter timeframe.

(d) An *authorised fund manager* should pay particular attention to the least liquid assets in its portfolio and the impact which they could have on the overall liquidity profile of the *scheme*.

(3)

(a) With respect to liquidity thresholds, an *authorised fund manager* should ensure that its liquidity risk management system is based on appropriate liquidity thresholds which are proportionate to the *redemption* obligations and other liabilities of a *scheme*. For this purpose, the other liabilities of a *scheme* include non-*redemption* pressures, such as *margin* and *collateral* calls from *derivative* counterparties.

[**Note**: See *COLL* 6 Annex 4.9.1 to *COLL* 6 Annex 4.9.4]

(b) The appropriateness of the liquidity thresholds will depend on factors such as the *scheme's* investment strategy, its investor base and its *redemption* policy.

(c) An *authorised fund manager* should set liquidity thresholds to ensure that the *scheme's redemption* terms remain aligned with its liquidity profile, both in normal and stressed market conditions, and should consider whether these are appropriate for its underlying investor base.

6 Annex 4.3.3 G In designing its liquidity risk management system, an *authorised fund manager* should also have regard to the *guidance* in *COLL* 6 Annex 4.4.1 to *COLL* 6 Annex 4.9.5.

Governance

6 Annex 4.4.1 G (1) An *authorised fund manager* should ensure that liquidity risk management forms a prominent part of its governance arrangements and is integrated into its permanent risk management function.

[**Note**: See *COLL* 6.11.4R (Duties of the permanent risk management function)]

(2) An *authorised fund manager* should have an internal governance framework that has appropriate representation from all areas of the *firm*, including risk and distribution, while having a robust internal

conflicts management system in place to ensure that the interests of the *unitholders* are prioritised.

[**Note**: See *SYSC* 10]

6 Annex 4.4.2 G (1) An *authorised fund manager* should put in place arrangements for detailed liquidity reporting, which should be presented to its relevant governance committees.

(2) The detailed liquidity reporting should include *redemption* trends and the evolution of liquidity buckets, particularly when *redemptions* and declining liquidity coincide.

6 Annex 4.4.3 G An *authorised fund manager* should establish and document protocols for escalating liquidity issues and increasing governance frequency during volatile market conditions.

6 Annex 4.4.4 G An *authorised fund manager's* internal governance arrangements should include, at a minimum:

(1) objective criteria for making decisions and for the application of liquidity management tools;

(2) a clear methodology, including calibration, of liquidity management tools;

(3) the identification of the relevant parties involved (for example, *senior personnel*, risk management, administration), their respective functions and responsibilities, and the system in place for coordinating their respective inputs;

(4) the sources of information and data used;

(5) the controls to be carried out (including reviews on the use of liquidity management tools) and their frequency;

(6) the documentation of recommendations and decisions made about the use of liquidity management tools and the basis for them; and

(7) the escalation processes and oversight in place to ensure governance by the *governing body*.

6 Annex 4.4.5 G (1) An *authorised fund manager* should ensure that *persons* of suitable seniority, who individually or collectively possess adequate skills and knowledge, are involved in decisions about liquidity risk management and the use of liquidity management tools.

(2) An *authorised fund manager* should have an informed understanding of, or reliable data about, all relevant aspects of the *scheme* to support its recommendations and decisions, for example:

(a) the investor profile of the *scheme*;

(b) historical and predicted inflows and outflows of cash;

(c) information about the current state of the markets for the assets held, including current bid-ask spread information, executed prices and differences with quoted bid-ask prices;

(d) assessments of the ability to execute transactions in underlying assets, in terms of likely market impact of transacting in average or above-average lot sizes;

(e) liquidity stress testing data; and

(f) operational readiness to apply or adjust liquidity management tools, both for the *authorised fund manager* and its delegates or agents, and for others in the distribution network.

6 Annex 4.4.6 G (1) An *authorised fund manager's* oversight process should result in adequate and timely management information being produced and reported to its *senior personnel* and *governing body*.

(2) The content and amount of management information to be produced and the decision as to who within the *firm* is best placed to consider it, should be decided in a proportionate way, taking account of the size of the *authorised fund manager*, the characteristics of the *scheme* it manages and the levels of management within its corporate structure.

(3) The *authorised fund manager's governing body* should consider the information reported to it and address appropriately any weaknesses that have been identified.

6 Annex 4.4.7 G The process set out at *COLL* 6 Annex 4.4.6 above should ensure that an *authorised fund manager's* most senior level of management explicitly considers liquidity risk management processes on a periodic basis to satisfy itself that the processes are adequate and are operating in the best interests of investors in the *scheme*.

Dealing arrangements

6 Annex 4.5.1 G (1) With respect to the requirements in *COLL* 6.2.16R (Sale and redemption), an *authorised fund manager* has discretion to determine the frequency of dealing days within limits and may take the power to use certain liquidity management mechanisms for some *schemes*, such as *deferred redemption* for some kinds of *non-UCITS retail schemes*, to manage the volume of redemption requests.

[**Note**: See *COLL* 6.2.21R (Deferred redemptions)]

(2) However, the obligation to carry out a *redemption* request for an individual *unitholder* cannot be set aside unless it is in the best

interests of the *scheme* and all its *unitholders* for that *redemption* not to proceed. In these circumstances, suspension of *dealing* in the *scheme* is likely to be in the best interests of all *unitholders*.

[**Note**: See *COLL* 7.2 (Suspension and restart of dealings)]

(3) Suspension should be considered a liquidity management tool of last resort, to be employed when needed but only when no other technique for managing liquidity will adequately protect *unitholders'* interests.

6 Annex 4.5.2 G An *authorised fund manager* should have a comprehensive contingency plan in place for when a suspension is required, which takes account of the fact that the suspension not only impacts *unitholders* in the suspended *fund*, but may lead to a loss of confidence in other *schemes* managed by the *authorised fund manager*, or *schemes* with similar investment strategies which are managed by other *authorised fund managers*.

Redemption processes

6 Annex 4.6.1 G (1) An *authorised fund manager* should closely monitor levels of *redemption* requests taking account of large *redemptions* and cumulative smaller *redemptions*.

(2) An *authorised fund manager* should, as part of its monitoring, have an appropriate escalation process in place for both large *redemptions* and cumulative smaller *redemptions*.

(3) For the purposes of (2), an *authorised fund manager* should not rely solely on third-party administrators.

6 Annex 4.6.2 G (1) An *authorised fund manager* should, when meeting *redemption* requests, consider carefully the interests of the remaining *unitholders*, especially where the *scheme* holds less liquid assets, and should avoid a scenario in which the remaining *unitholders* in the *scheme* are left with an increasingly illiquid portfolio.

(2) An *authorised fund manager* should therefore have a process for considering alternative solutions to meet sudden large *redemptions* in *schemes* with a concentrated portfolio or investor base, or both.

Liquidity management tools

6 Annex 4.7.1 G (1) An *authorised fund manager* should select the liquidity management tools which are most suited to the *scheme's* investor base, investment strategy and liquidity profile.

(2) An *authorised fund manager* should put in place and periodically test contingency plans with the aim of ensuring that its liquidity management tools can be used in a prompt and orderly manner.

6 Annex 4.7.2	G	(1)	An *authorised fund manager* should have policies in place as to when it will consider using its liquidity management tools.
		(2)	The policies should be documented, sufficiently detailed and accessible to the *authorised fund manager's* relevant decision makers.
6 Annex 4.7.3	G	(1)	An *authorised fund manager* should not rely exclusively on quantity-based liquidity management tools, for example, deferral of *redemptions* or suspension.
		(2)	An *authorised fund manager* should, in the first instance, make use of anti-*dilution* tools to mitigate material investor *dilution* and potential first-mover advantage. Such anti-*dilution* tools include: (a) swing pricing (*dilution adjustment* or *dilution levy*) for *single-priced authorised funds*; and (b) the setting of an appropriate dealing spread for *dual-priced authorised funds.*
		(3)	Anti-*dilution* tools should support good liquidity management by ensuring the fair allocation of costs to transacting *unitholders* while reducing (and ideally eliminating) any possible first-mover advantage to some *redeeming unitholders* in a stressed market environment.
6 Annex 4.7.4	G		*COLL* 6.3.7BG(3) (Dilution) sets out *guidance* as to how the price-based mechanisms in *COLL* 6.3.7AR to *COLL* 6.3.8R should be calibrated.
6 Annex 4.7.5	G	(1)	An *authorised fund manager* should calculate the thresholds for the application of anti-*dilution* tools and their calibration on a *scheme*-by-*scheme* basis, rather than using a one-size-fits-all approach, taking into account both explicit and implicit costs, such as market impact.
		(2)	An *authorised fund manager* should assess the *dilution* risk at each *valuation point* although, in the case of a *single-priced authorised fund*, it may choose not to apply a *dilution adjustment* or *dilution levy* where it has reasonably assessed that the *dilution* risk is not material.
			Stress testing
6 Annex 4.8.1	G	(1)	An *authorised fund manager* should carry out stress testing in line with *COLL* 6 Annex 5 (Guidance notes on liquidity stress testing in UCITS schemes and non-UCITS retail schemes).
		(2)	An *authorised fund manager* should integrate stress testing into all stages of the *scheme's* life cycle, including in the product design stage when determining the *dealing* and distribution arrangements

and portfolio composition, and in carrying out investment and liquidity risk management on an ongoing basis.

6 Annex 4.8.2	G	An *authorised fund manager* should use the results of stress testing to:	
		(1)	determine and assess the appropriate *dealing* arrangements for each *scheme* in light of its investment strategy and underlying assets, even under stressed scenarios;
		(2)	consider if any adjustments are necessary to the *scheme's dealing* arrangements, investment strategy and underlying assets (including the holdings of liquid assets);
		(3)	formulate action and contingency plans to use different liquidity management tools to deal with plausible stressed market conditions; and
		(4)	ensure that the *scheme* holds sufficient liquid assets and eligible *collateral* to meet *margin* and *collateral* calls in a timely manner, including in extreme but plausible stressed conditions.
6 Annex 4.8.3	G	(1)	An *authorised fund manager* should ensure that the performance and oversight of stress testing is sufficiently independent from the portfolio management function.
		(2)	In general, stress testing should be performed by the *authorised fund manager's* risk management function, with inputs from other relevant functions such as its portfolio management and trading functions.
		(3)	The results of stress testing should be reviewed by the *authorised fund manager's* governance committee responsible for liquidity risk management, and reported to its *senior personnel* and *governing body*.
		(4)	An *authorised fund manager* should maintain appropriate information of its stress testing activities, particularly regarding whether any actions are taken in light of the stress testing results. The *authorised fund manager* should be able to provide the relevant information to the *FCA* upon request.
	Non-redemption pressures		
6 Annex 4.9.1	G	(1)	An *authorised fund manager* should consider risks arising from any *securities financing transaction* in *derivative*s or *transferable securities* to which it is a party.
		(2)	For this purpose, an *authorised fund manager* should consider:

(a) the potential for increases in variation *margin* and *collateral* calls due to adverse market price movements;

(b) the potential for counterparties, to increase initial *margin* and haircuts; and

(c) the risk that counterparties to a *securities financing transaction* terminate or refrain from 'rolling over' existing financing arrangements in stress.

(3) An *authorised fund manager* should:

(a) regularly assess *collateral* quality (for example, assessing for any deterioration in the liquidity of *transferable securities* held as *collateral*); and

(b) ensure that the *scheme* holds a sufficient quantity of liquid assets and eligible *collateral* to meet *margin* or *collateral* calls in a timely manner, including in extreme but plausible stressed conditions.

6 Annex 4.9.2 G (1) An *authorised fund manager* should regularly assess the diversification of its eligible *collateral* and minimise its credit risk, liquidity risk and *market risk* to ensure that the amount of *collateral* remains sufficient.

(2) An *authorised fund manager* may also consider the use of credit lines and/or the expansion of the range of eligible *collateral* under its financing agreements to reduce the need to hold *cash collateral*, where appropriate.

(3) An *authorised fund manager* should be able to:

(a) identify potential intra-day *margin* and *collateral* call requirements and ensure capacity to make timely delivery;

(b) monitor the amounts of readily available *cash* and non-*cash collateral* and ensure that it can make timely delivery in the relevant market; and

(c) identify, monitor, and manage *collateral* disputes with its counterparties to *derivatives* and *securities financing transactions*.

(4) An *authorised fund manager* should have adequate *collateral* management systems and processes to ensure the timely delivery of *margin* calls, including during stressed conditions.

(5) When designing these systems and processes, an *authorised fund manager* should consider the costs and benefits of:

(a) outsourcing certain aspects to third parties;

(b) standardisation and/or automation to maximise capacity to make timely delivery during periods of heightened market activity; and

(c) holding excess *collateral* in normal market conditions to reduce the impact of increased *margin* and *collateral* calls during stressed conditions.

6 Annex 4.9.3 G (1) An *authorised fund manager's* cash and *collateral* management systems should be:

(a) commensurate with the size, nature and complexity of the *authorised fund manager's* transactions to ensure processes are well-designed and operationally resilient; and

(b) subject to frequent review.

(2)

(a) An *authorised fund manager* should test the operational readiness of its systems and the resilience of its third-party service providers under stressed conditions.

(b) For the purposes of (a), an *authorised fund manager* should test that *collateral* is unencumbered and accessible in the required timeframe, with prudent safeguards where re-hypothecation is used.

6 Annex 4.9.4 G (1) An *authorised fund manager* should maintain active, transparent and regular bilateral contact with counterparties and third-party *collateral* managers to identify and manage potential liquidity risks in plausible stress events.

(2) Such contact should occur at least annually or after a stress event and consider how counterparties' risk management practices will respond to a stress.

6 Annex 4.9.5 G An *authorised fund manager's* liquidity risk management system should capture the operational risks of using a third party, including ensuring adequate operational resilience to manage stressed conditions.

Further information

6 Annex 4.10.1 G (1) The *guidance* in this Annex takes account of *IOSCO's* report on 'Revised Recommendations for Liquidity Risk Management for Collective Investment Schemes'.

[**Note**: See https://www.iosco.org/library/pubdocs/pdf/IOSCOPD798.pdf]

(2) The *IOSCO* recommendations include further material on aspects of liquidity risk management which an *authorised fund manager* is recommended to consider.

(3) *IOSCO* has also published guidelines: 'IOSCO Guidance for Open-Ended Funds for Effective Implementation of the Recommendations for Liquidity Risk Management'.

[**Note**: See https://www.iosco.org/library/pubdocs/pdf/IOSCOPD799.pdf]

(4) The *IOSCO* guidelines contain examples of good practice in several jurisdictions that may be helpful to an *authorised fund manager* for developing procedures and processes for managing liquidity risk.

6 Annex 5 **Guidance notes on liquidity stress testing in UCITS schemes and non-UCITS retail schemes**

This Annex belongs to *COLL* 6.12.11AG (Measurement and management of risk) and *FUND* 3.6.3AG (Liquidity systems and procedures).

Definitions

6 Annex 5.1.1 G (1) In this Annex, the terms specified in column (1) of the table in *COLL* 6 Annex 5.1.2G have the definitions given in column (2).

(2) The terms defined in *COLL* 6 Annex 5.1.2 are not italicised in this Annex.

6 Annex 5.1.2 G This table belongs to *COLL* 6 Annex 5.1.1:

Term (1)	**Definition (2)**
ex-post additional liquidity management tools	tools or measures applied by an *authorised fund manager* in exceptional circumstances to control or limit dealing in *units* or *shares* in the interests of investors, including but not limited to suspension of dealing in *units,* deferral of dealing and the creation of a *side pocket class*.
fire sale	liquidation of *scheme property* at a material discount to its fair value.
liquidation cost	the cost paid by the seller of *scheme property* for the execution of a given transaction in a timely manner for liquidity purposes.

liquidity stress testing	a risk management tool within the overall liquidity risk management framework of an *authorised fund manager* which simulates a range of conditions, including normal and stressed (i.e. extreme, unlikely or unfavourable) plausible conditions, to assess their potential impact on assets and liabilities, *scheme property*, overall liquidity of a *fund* and the necessary follow-up action.
redemption coverage ratio	a measurement of the extent to which the *authorised fund's scheme property* will be sufficient to meet funding obligations arising from the liabilities side of the balance sheet, such as a high level of *redemption* requests.
reverse stress testing	a *fund*-level stress test which starts from the identification of the pre-defined outcome with regards to *fund* liquidity (e.g. the point at which the *fund* would no longer be liquid enough to meet requests to *redeem units* or to meet *margin* and *collateral* calls) and then explores scenarios and circumstances that might cause this to occur.
special arrangements	specific types of ex-post additional liquidity management tools or measures available to some *schemes* and which impact investors' *redemption* rights, such as *limited redemption arrangements*.
time to liquidity	an approach, whereby an *authorised fund manager* can estimate the amount of *scheme property* which could be liquidated at an acceptable cost, for a given time horizon.

Scope: who?

6 Annex 5.2.1 G This *guidance* applies to *authorised fund manager*s and *depositaries* of *UCITS schemes* and *non-UCITS retail schemes*.

Scope: what?

6 Annex 5.2.2 G This *guidance* relates to liquidity stress testing in *UCITS schemes* and *non-UCITS retail schemes*.

6 Annex 5.2.3 G In relation to *money market funds*, the following *guidance* in this Annex applies to the extent that it does not conflict with the *Money Market Fund Regulations*:

(1) *COLL* 6 Annex 5.3.1 to *COLL* 6 Annex 5.3.2 (The design of liquidity stress testing models);

(2) *COLL* 6 Annex 5.3.3 to *COLL* 6 Annex 5.3.4 (Understanding liquidity risk);

(3) *COLL* 6 Annex 5.3.5 to *COLL* 6 Annex 5.3.8 (Governance principles for liquidity stress testing);

(4) *COLL* 6 Annex 5.3.9 (The liquidity stress testing policy); and

(5) *COLL* 6 Annex 5.3.57 to *COLL* 6 Annex 5.3.60 (The role of depositaries).

6 Annex 5.2.4 G (1) This *guidance* should be adapted to the nature, scale and complexity of a *scheme*.

(2) Liquidity stress testing naturally overlaps with other aspects of liquidity management in a *scheme*, such as managing liquid assets and less liquid assets, diversification and implementing measures such as ex-post additional liquidity management tools.

(3) This *guidance* is not intended to be comprehensive regarding liquidity management issues outside the scope of liquidity stress testing.

Liquidity stress testing: the design of liquidity stress testing models

6 Annex 5.3.1 G In building liquidity stress testing models, an *authorised fund manager* should determine:

(1) the risk factors that may impact a *scheme's* liquidity;

(2) the types of scenarios to use and their severity;

(3) different outputs and indicators to be monitored based on the results of the liquidity stress testing;

(4) the reporting of liquidity stress testing results, outputs and indicators to management; and

(5) how the results of liquidity stress testing are used by the risk management function, the portfolio management function and by *senior personnel*.

6 Annex 5.3.2 G An *authorised fund manager* should ensure that liquidity stress testing provides information that enables follow-up action.

Understanding liquidity risks

6 Annex 5.3.3 G An *authorised fund manager* should have a strong understanding of the liquidity risks arising from *scheme property* and liabilities on the *scheme's* balance sheet, and its overall liquidity profile, in order to employ liquidity stress testing that is appropriate for each *scheme* it manages.

6 Annex 5.3.4 G An *authorised fund manager* should employ liquidity stress testing that:

(1) is adequately focused, specific to the *scheme* and highlights the key liquidity risk factors; and

(2) uses a wide enough range of scenarios to adequately represent the diversity of the *scheme*'s risks.

Governance principles for liquidity stress testing

6 Annex 5.3.5 G (1) An *authorised fund manager* should integrate and embed liquidity stress testing into the *scheme's* risk management framework supporting liquidity management.

(2) A *scheme's* liquidity stress testing should be subject to appropriate governance and oversight, including appropriate reporting and escalation procedures.

6 Annex 5.3.6 G (1) An *authorised fund manager* should perform liquidity stress testing under similar conditions to other risk management operations that are subject to regulatory requirements on independence, including the requirement for risk management staff to act independently from other functions such as portfolio management.

(2) Nevertheless, the governance structure should consider how the outcome of liquidity stress testing is taken into consideration by the portfolio management function while managing the *scheme*.

6 Annex 5.3.7 G Where an *authorised fund manager* delegates portfolio management to a third party, it should pay particular attention to the independence requirement, in order to avoid reliance on, or influence by, the third party's own liquidity stress testing.

6 Annex 5.3.8 G (1) An *authorised fund manager* should, as part of its organisational arrangements, have procedures to effectively manage conflicts of interest arising from operationalising liquidity stress testing.

(2) An *authorised fund manager* should not allow other parties, such as portfolio management staff (including *portfolio managers* from separate legal entities), to exercise undue influence over the execution of liquidity stress testing, including reliance on judgements relating to asset liquidity.

(3) Where an *authorised fund manager* shares information regarding the results of stress tests with a *unitholder*, an investor, or a *person*

who offers, recommends or *sells units* in the *scheme* to investors (or arranges to do so), the *authorised fund manager* should ensure that this would not be inconsistent with its obligation to treat all investors fairly in the way it discloses information regarding the *scheme*.

The liquidity stress testing policy

6 Annex 5.3.9	G	(1)	Liquidity stress testing should be documented in a liquidity stress testing policy within the *UCITS scheme's* or *non-UCITS retail scheme's* risk management process, which should require an *authorised fund manager* to review the liquidity stress testing periodically and adapt it as necessary.
		(2)	The liquidity stress testing policy should include at least the following:

(a) the name of the *scheme* that is subject to liquidity stress testing;

(b) its internal ownership and which management function(s) are responsible for its performance;

(c) the frequency at which liquidity stress testing is carried out and the reasons for selecting that frequency;

(d) its interaction with other liquidity risk management procedures, including portfolio management and an *authorised fund manager*'s contingency plans;

(e) a requirement for regular internal reporting of liquidity stress testing results specifying the frequency and recipients of the report;

(f) a clear definition of the role of *senior personnel* in the process, including the role of the *governing body*;

(g) the circumstances requiring escalation, including when liquidity limits or thresholds are breached;

(h) initial validation of the liquidity stress testing models and assumptions underpinning them, which should be performed independently from portfolio management, though not necessarily by an entity or *person* external to the *authorised fund manager*;

(i) the types and severity of stress test scenarios used and the reasons for selecting those scenarios;

(j) the assumptions used, relating to data availability for the scenarios, their rationale and how frequently they are revisited;

(k) the methods for liquidating *scheme property*, including the limitations and assumptions used; and

(l) periodic review, documentation of the results and a procedure for amending the policy where required by the review.

Frequency of liquidity stress testing

6 Annex 5.3.10 G (1) Liquidity stress testing should be carried out at least quarterly at all stages in a *scheme's* lifecycle or more frequently as *an authorised fund manager* considers appropriate.

(2) The reasons for determining when to undertake more frequent stress testing should be recorded in the liquidity stress testing policy.

6 Annex 5.3.11 G When deciding on the appropriate frequency of liquidity stress testing, an *authorised fund manager* should take into account the following:

(1) the *scheme's* characteristics, including its nature, scale and complexity and liquidity profile;

(2) the liquidity of the *scheme* as determined by the *authorised fund manager* and any change in the liquidity of *scheme property*;

(3) the need to adapt the frequency according to the nature of the particular *scheme,* rather than taking a 'one-size-fits-all' approach to all *schemes* operated by the *authorised fund manager*; and

(4) the circumstances in which liquidity management tools, such as *limited redemption arrangements* may be used.

6 Annex 5.3.12 G (1) An *authorised fund manager* should take into account the factors described in the table at (2) when determining the appropriate frequency of liquidity stress testing.

(2) This table belongs to (1).

	Factor	**Practice or considerations**	
(1)	Recommended frequency of liquidity stress testing	(a)	Quarterly, unless a higher frequency is justified by the characteristics of the *scheme*.

		(b)	The justification for the frequency of liquidity stress testing should be recorded in the liquidity stress testing policy.
(2)	Factors which may may increase the frequency of regular liquidity stress testing	Such factors include:	
		(a)	high frequency in *dealing* in *units*;
		(b)	increased risks emanating from liabilities, such as a concentrated investor base;
		(c)	a complex investment strategy (e.g. extensive use of *derivatives*);
		(d)	a less liquid *scheme property* base; and
		(e)	a forthcoming event which could negatively affect *fund* liquidity.
(3)	Factors which may decrease the frequency of regular liquidity stress testing	Such factors include:	
		(a)	a highly liquid *scheme property* base; and
		(b)	less frequent *dealing* in *units*.
(4)	Recommended employment of ad-hoc liquidity stress testing	Ad-hoc liquidity stress testing should be undertaken as soon as practicable if a material risk to *scheme* liquidity is identified by the *authorised fund manager* and requires being addressed in a timely manner.	

The use of liquidity stress testing outcomes

6 Annex 5.3.13 G Liquidity stress testing should produce outputs which:

(1) help ensure the *scheme* is sufficiently liquid, as required by applicable *rules* and *redemption* terms stipulated in *scheme* documentation;

(2) strengthen an *authorised fund manager*'s ability to manage *scheme* liquidity in the best interests of investors, including in planning for periods of heightened liquidity risk;

(3) help an *authorised fund manager* to identify potential liquidity weaknesses in an investment strategy and assist in investment decision-making; and

(4) assist risk management monitoring and decision-making, including setting relevant internal limits as an additional risk management tool – this may include ensuring the results of liquidity stress testing can be measured through a comparable metric, such as a key risk indicator.

6 Annex 5.3.14 G (1) Liquidity stress testing should assist an *authorised fund manager* in preparing a *scheme* to adapt to a crisis, and in its broader contingency planning.

(2) Such contingency planning may involve an *authorised fund manager's* plans to use any ex-post additional liquidity management tools in relation to a *scheme*.

Adapting the liquidity stress testing to each fund

6 Annex 5.3.15 G An *authorised fund manager* should adapt liquidity stress testing appropriately to each *scheme*, including by adapting:

(1) the frequency of liquidity stress testing;

(2) the types and severity of scenarios to employ to create stressed conditions, which should always be sufficiently severe but plausible and should be based on the liquidity risks arising from the assets and liabilities of the *scheme's* balance sheet as well as its overall liquidity profile;

(3) the assumptions regarding investor behaviour (gross and net *redemptions*) and the liquidation of *scheme property*;

(4) the complexity of the liquidity stress testing model, which should account for the complexity of the *scheme's* investment strategy, portfolio composition, liquidity management tools and use of *efficient portfolio management* techniques; and

(5) in the case of an *ETF*, its specificities – for example, by taking into account the role of authorised participants, *redemption* models and replication models.

Liquidity stress testing scenarios

6 Annex 5.3.16	G	Liquidity stress testing should:	
		(1)	employ hypothetical and historical scenarios and reverse stress testing; but
		(2)	not rely overly on historical data, particularly as future stresses may differ from previous ones.
6 Annex 5.3.17	G	An *authorised fund manager* should choose historical scenarios which are most appropriate to the strategy of the *scheme* such as, for example, rising interest rates, credit spread widening, or political events.	
6 Annex 5.3.18	G	(1)	An *authorised fund manager* using reverse stress testing should simulate *scheme property* being liquidated in a way that reflects how the *authorised fund manager* would liquidate *scheme property* during a period of exceptional market stress.
		(2)	Reverse stress testing should take into account the treatment of remaining, as well as *redeeming*, *unitholders* as well as the role of transaction costs and whether or not fire sale prices would be accepted.
6 Annex 5.3.19	G	An *authorised fund manager* of a *scheme* that engages in investment strategies exposing them to low-probability risks with a potentially high impact should pay particular regard to the use of reverse stress testing to assess the consequences of an extreme market event for their liquidity profile.	
6 Annex 5.3.20	G	(1)	Reverse stress testing can be used to establish whether action needs to be taken to ensure a *scheme* is adequately liquid, or whether such a circumstance would be exceptional enough to warrant suspension of dealing in compliance with applicable rules.
		(2)	In the case of a *UCITS scheme*, the 'exceptional circumstances' are those within the meaning of *COLL* 7.2.1R (Requirement) and the *scheme's prospectus*.
6 Annex 5.3.21	G	An *authorised fund manager* of a *non-UCITS retail scheme* may also use reverse stress testing to simulate the level of *scheme property* that may be liquidated before implementing special arrangements allowed by its *redemption* policy.	

Data availability

6 Annex 5.3.22	G	Liquidity stress testing should demonstrate that an *authorised fund manager* is able to overcome limitations related to the availability of data, including by:

(1) avoiding optimistic assumptions;

(2) justifying reliance on third parties' liquidity stress testing models, including where the model is developed by a third-party portfolio manager; and

(3) exercising expert qualitative judgement.

6 Annex 5.3.23 G In particular, an *authorised fund manager* should adapt its approach where data is limited and any assumptions used should be adequately reviewed.

6 Annex 5.3.24 G (1) Appropriate reductions in *scheme property* liquidity should be simulated in times of both normal and stressed market conditions, particularly where historical data does not provide sufficiently severe examples of stressed conditions.

(2) It should not be assumed that a portfolio can be liquidated at the full average daily traded volume of an asset unless such an assumption can be justified based on empirical evidence.

Product development

6 Annex 5.3.25 G During product development, an *authorised fund manager* should:

(1) be able to demonstrate to the *FCA* that key elements of the *fund*, including its strategy and dealing frequency, enable it to remain sufficiently liquid during normal and stressed circumstances; and

(2) where appropriate, undertake liquidity stress testing on the *scheme property* side (using a model portfolio) as well as on the liability side, incorporating the expected investor profile both from the early and late stages of the *scheme's* existence.

6 Annex 5.3.26 G Liquidity stress testing can also be used on establishing a *scheme* to help identify factors material to the future risk management of the *scheme*. For example:

(1) quantifying the sensitivity of the *scheme's* liquidity risk;

(2) identifying factors impacting liquidity risk;

(3) identifying metrics and key risk indicators to monitor liquidity risk going forward;

(4) identifying the frequency of risk management; and

(5) assessing any potential ex-post additional liquidity management tools or special arrangements to be included in the *prospectus*.

Stress testing scheme property to determine the effect on fund liquidity

6 Annex 5.3.27	G	Liquidity stress testing should enable an *authorised fund manager* to assess not only the time and/or cost to liquidate *scheme property* in a portfolio, but also whether such an activity would be permissible, taking into account: (1) the objectives and investment policy of the *scheme*; (2) the obligation to manage the *scheme* in the interests of investors; (3) any applicable obligation to liquidate *scheme property* at limited cost; and (4) the obligation to maintain the risk profile of the *scheme* following liquidation of a portion of its *scheme property*.
6 Annex 5.3.28	G	(1) Liquidation cost and time to liquidity are the two principal approaches typically employed by an *authorised fund manager* to simulate the liquidity of *scheme property* under normal and stressed conditions. (2) An *authorised fund manager* should apply the appropriate method for the individual *scheme*. (3) Approaches other than those at (1) may also be adopted for the *scheme.*
6 Annex 5.3.29	G	An *authorised fund manager* should consider the following factors when assessing the liquidation cost of *scheme property* under normal and stressed conditions: (1) the type of *scheme property*; (2) the liquidation horizon; and (3) the size of the trade or order.
6 Annex 5.3.30	G	An *authorised fund manager* should reflect a significant number and variety of market stresses in the estimation of the liquidation cost and time to liquidation under stressed conditions, which are typically characterised by higher volatility, lower liquidity (eg, higher bid-ask spreads) and longer time to liquidate (depending on asset class). Reference should not be made only to historical observations of stressed markets.
6 Annex 5.3.31	G	(1) An *authorised fund manager* should choose the method of liquidating *scheme property* in liquidity stress testing, taking into account the assets and liabilities, as well as the *redemption* terms, of a *scheme*. (2) An *authorised fund manager* should also be aware of the limitations in the chosen method and make conservative adjustments to its broader liquidity risk management to mitigate those limitations.

6 Annex 5.3.32	G	The method of liquidating *scheme property* in a liquidity stress test should: (1) reflect how an *authorised fund manager* would liquidate *scheme property* during normal and stressed conditions in accordance with regulatory requirements and any limitations specific to a *scheme* as imposed by the *prospectus*; (2) where an *authorised fund manager* opts to reduce its exposure to *derivatives* rather than liquidate assets, reflect the time and/or cost required to do so, as well as the liquidity generated, for example through the release of initial *margin*; (3) ensure the model used for a *scheme* stays in compliance with its investment objectives and policy; (4) reflect the *scheme* being managed in the interests of all investors, both those *redeeming* and remaining; (5) comply with applicable obligations for a *scheme* to maintain the risk profile envisaged by *scheme* documentation; (6) be reflected in the liquidity stress testing policy; and (7) take into account, where relevant, the potential negative effects on other investors or on overall market integrity.
	Stress testing fund liabilities to determine the effect on fund liquidity	
6 Annex 5.3.33	G	Liquidity stress testing should incorporate scenarios relating to the liabilities of a *scheme*, including both *redemptions* and other potential sources of risk to liquidity emanating from the liability side of the *scheme's* balance sheet.
6 Annex 5.3.34	G	Liquidity stress testing should incorporate risk factors related to investor type and concentration according to the nature, scale and complexity of a *scheme*.
6 Annex 5.3.35	G	An *authorised fund manager* should take into account the following when considering liquidity risk scenarios: (1) *redemption* requests are likely to be the most common and typically most important source of liquidity risk for a *scheme*; (2) additionally, different types of liabilities on a *scheme's* balance sheet and their potential impact on *scheme* liquidity may vary, according to the nature of the *scheme*; and (3) special arrangements or additional liquidity management tools may be considered when managing liability risk.

6 Annex 5.3.36	G	(1)	For normal conditions, an *authorised fund manager* may decide to monitor the historical outflows (average and trends over time), average *redemptions* of a peer *scheme*, and information from any distribution network regarding forecast *redemptions*.
		(2)	An *authorised fund manager* should ensure that the time series is long enough to fairly reflect 'normal' conditions.
6 Annex 5.3.37	G		For stressed conditions, example scenarios include historical trends, historical events, contemporary trends in a peer *scheme*, hypothetical or event-driven scenarios and reverse stress testing.
6 Annex 5.3.38	G		Depending on the availability of granular historical data covering *redemptions* for each investor type and other information relative to a *scheme's* specific distribution, an *authorised fund manager* may also simulate *redemption* requests for different types of investors.
6 Annex 5.3.39	G	(1)	An *authorised fund manager* should take into account the extent to which variables arising from additional factors such as investor behaviour can or should be incorporated into liquidity stress testing model scenarios.
		(2)	Decisions on the granularity, depth of analysis and use of data are subject to necessity and proportionality.
		(3)	An *authorised fund manager* should understand the potential risks associated with a *scheme's* investor base and be able to demonstrate that those risks play a material factor in the ongoing liquidity risk management of the *scheme*.
6 Annex 5.3.40	G	(1)	The table in (2) provides examples of factors regarding investor behaviour which may be incorporated into the liquidity stress testing model.
		(2)	This table belongs to (1):

Factor	Examples of potential liquidity risk	Examples of potential incorporation into liquidity stress testing

<table>
<tr><td>(1)</td><td>Investor category</td><td colspan="2">Redemption risk may vary by type of investor. For example, the likelihood of redeeming during stressed conditions could be categorised according to whether investors are wealth managers, pension schemes, platform service providers, direct retail investors, or other UCITS schemes or non-UCITS retail schemes.</td><td>Based on an authorised fund manager's knowledge and experience of investors, the liquidity stress testing model may simulate, for example, a scheme that invests in other schemes posing more redemption risk than other types of investors, and simulate its withdrawal from the target scheme(s) first.</td></tr>
<tr><td>(2)</td><td>Investor concentrat ion</td><td colspan="2">One or more investors may own a materially larger proportion of a scheme than others, leading to a particular risk to scheme liquidity from the investor(s) redeeming.</td><td>An authorised fund manager may model one, or a number of, the largest investors redeeming simultaneously from a scheme over a given period of time (although this may have limited utility where all unitholders are institutional investors that co-operate with the authorised fund manager concerning their intentions to deal in units).</td></tr>
<tr><td rowspan="2">(3)</td><td rowspan="2">Investor location</td><td>(a)</td><td>Investors located in different regions or countries may pose a distinct redemption risk due to idiosyncratic factors linked to the political, economic or other factors relating to their location.</td><td rowspan="2">An authorised fund manager may simulate a material proportion of investors located in a specific country redeeming over a given time period first.</td></tr>
<tr><td>(b)</td><td>For example, investors in a region subject to different monetary policy may pose distinct redemption</td></tr>
</table>

			risks during periods of changes in FX and/or interest rates.	
		(c)	Political and/or economic risks may also lead investors in other regions or countries to *redeem units*.	
(4)	Investor strategy	(a)	Whilst many investors' strategies are long-term and, in any case, challenging to unpick, some investors follow formulaic or pre-defined strategies that may pose particular *redemption* risks in changing market conditions.	An *authorised fund manager* may simulate *redemptions* from investors following similar strategies in stressed and normal market conditions.
		(b)	For example, some *schemes* explicitly seek to target a level of risk, as measured by volatility, and are identifiable as such via their *scheme* names and stated investment objectives.	
		(c)	*Schemes* such as those referred to in (b) often seek to de-risk during volatile periods and may pose heightened *redemption* risk during periods of volatility in given asset classes.	

		(d)	Where *schemes* with formulaic or pre-defined strategies are investors, an *authorised fund manager* may need to pay due regard to the liquidity risk such *schemes* pose during stressed and normal market conditions.	

Liquidity stress testing on other types of liabilities

6 Annex 5.3.41	G	(1)	An *authorised fund manager* should be aware that net *redemptions* may not be the only relevant risk to liquidity coming from the liability side of a *scheme's* balance sheet which should be subject to liquidity stress testing.
		(2)	An *authorised fund manager* should include all other relevant types of liabilities in its liquidity stress testing in normal and stressed conditions, where appropriate.
6 Annex 5.3.42	G	(1)	In some cases, liquidity stress testing should determine the circumstances in which liquidity risk cannot be mitigated, for example a level of *margin* calls a *scheme* would not be able to fund.
		(2)	An *authorised fund manager's* contingency planning should adequately reflect the circumstances identified in (1) and help to mitigate the liquidity risk in such circumstances.
6 Annex 5.3.43	G	(1)	The table in (2) provides examples of factors which may affect liquidity risk.
		(2)	This table belongs to (1):

Liability type		**Examples of factors which may affect liquidity risk**	**Potential events which may be simulated**
(1)	*Derivatives*	Changes in the value of the underlying may lead to *margin* calls, affecting the available liquidity of a *scheme*.	Simulation of a change in the value of the underlying of the *derivative* leading to a larger than

			anticipated *margin* call.
(2)	Committed capital	A *scheme* investing in real or immovable assets is often required to commit capital to service the investment, such as maintenance or refurbishment costs.	Simulation of an unexpected event causing new or higher outlay of capital to a real estate investment.
(3)	*Securities financing transactions / efficient portfolio management*	A *scheme* borrowing against or lending out assets is exposed to *margin* and *collateral* calls as well as the *counterparty risk* of its counterparty and the associated liquidity risk arising from potential default – whilst this can be mitigated by the *collateral* posted, liquidity risk is not eliminated (bearing in mind the liquidity of the *collateral*).	Simulation of a change in the value of the *collateral* posted against a *scheme's* secured borrowing leading to a larger than anticipated *collateral* call. Simulation of default of the counterparty to a *securities financing transaction*. Simulation of *cash collateral* reinvestment risk
(4)	Interest / credit payments	A *scheme* which incorporates leverage into its investment strategy is subject to liquidity risk arising from factors such as interest rate sensitivity.	Simulation of increased interest rates on the payment obligations of a *scheme*.

Funds investing in less liquid assets

6 Annex 5.3.44 G Risks arising from less liquid *scheme property* and liabilities should be reflected in the liquidity stress testing.

6 Annex 5.3.45 G (1) Many *schemes* invested in less liquid assets or illiquid assets have distinct risks emanating from both assets and liabilities, compared to *schemes* investing in liquid *transferable securities*.

(2) For example, many *schemes* investing in real estate have less frequent dealing periods and notice periods which reduce liabilities risk from *redemptions*.

		(3)	However, such *schemes* are also exposed to distinct liabilities risks arising from servicing and maintaining real estate assets (including hard-to-simulate risks such as legal risks).
6 Annex 5.3.46	G	(1)	Furthermore, *schemes* investing in less liquid assets or illiquid assets have inherently less flexibility to improve overall liquidity by selling *scheme property* at a limited discount during periods of stressed market conditions.
		(2)	Therefore, the outputs from liquidity stress testing by an *authorised fund manager* of less liquid *scheme property* may have some distinctive features.
6 Annex 5.3.47	G	(1)	Low-probability but high-impact scenarios, including the potential difficulty of reliably pricing less liquid assets or illiquid assets during a period of market stress, will be important in respect of those assets.
		(2)	Such assets may be particularly vulnerable to an absence of liquidity in times of market stress, affecting time to liquidity, liquidation cost, and also whether or not assets would be liquidated at all when taking investors' best interests into consideration.
		(3)	Reverse stress testing may be a particularly valuable tool in this context, helping to identify scenarios which could lead to significant *scheme* liquidity risk (eg, identifying scenarios which would lead to the imposition of special arrangements or suspensions).
6 Annex 5.3.48	G	(1)	The nature of a less liquid *scheme property* base can place even more emphasis on the importance of an *authorised fund manager* ensuring that investors are treated impartially during stressed market conditions.
		(2)	Liquidity stress testing could therefore help an *authorised fund manager* to establish a governance framework seeking to support fair outcomes for all investors, by helping to model a fair method of liquidating *scheme property*.
6 Annex 5.3.49	G	(1)	One way in which an *authorised fund manager* could consider the liquidity of the *scheme* is to prioritise undertaking ad-hoc liquidity stress testing on *schemes* investing in less liquid assets or illiquid assets where a forthcoming event has been identified which could negatively impact *scheme* liquidity.
		(2)	An *authorised fund manager* should therefore pay particular regard to the appropriateness of the frequency of liquidity stress testing in *schemes* investing in less liquid assets or illiquid assets.
6 Annex 5.3.50	G	(1)	A *scheme* (the 'first *scheme*') which invests in one or more other *schemes* (a 'target *scheme*') and which gains indirect exposure to less liquid or illiquid assets via its target *schemes* should pay due regard to considerations relating to that exposure.

(2) Due regard should be paid to the assets of the target *scheme* because the underlying exposure of those target *schemes* may lead to the suspension of the target *scheme* or other measures. In turn, this may have an impact on the first *scheme* so its liquidity stress testing model should take this risk into account.

Combined asset and liability liquidity stress testing

6 Annex 5.3.51 G (1) An *authorised fund manager* should, after separately stress testing the assets and the liabilities of the *scheme* balance sheet, combine the results of the liquidity stress testing appropriately to determine the overall effect on *scheme* liquidity.

(2) Combined asset and liability liquidity stress testing can assist in the assessment of which *schemes* present the largest liquidity risk at a given moment, considering liquidity risk on both the assets and liabilities sides.

(3) The assessment at (1) can have a material role in an *authorised fund manager's* contingency planning for a crisis, such as in the planning for the impact of crystallised liquidity risk in one or more *schemes* at firm-level.

6 Annex 5.3.52 G An *authorised fund manager* should incorporate risk scoring into the liquidity stress testing where it enables an enhanced view of liquidity across the *scheme* range, including in contingency planning and operational preparations for a liquidity crisis.

6 Annex 5.3.53 G (1) An outcome of combined asset and liability liquidity stress testing may be a comparable metric or score, for example based on the *redemption* coverage ratio.

(2) An *authorised fund manager*'s chosen approach should be explained and documented in the liquidity stress testing policy.

(3) Where one *scheme* operated by an *authorised fund manager* can be compared to another using the metric or score, it can be a meaningful risk indicator for *senior personnel*.

6 Annex 5.3.54 G In cases where *scheme* scores or metrics change materially in a given timeframe, combined asset and liability liquidity stress testing can assist in the set-up of an alert system to assess whether action on a *scheme's* liquidity is required.

Aggregating liquidity stress testing across funds

6 Annex 5.3.55 G An *authorised fund manager* should aggregate liquidity stress testing across *schemes* under its management where it assesses such an activity to be appropriate for those *schemes*.

6 Annex 5.3.56	G	(1)	Aggregating liquidity stress testing across *schemes* involves utilising the same liquidity stress test on more than one *scheme* with similar strategies or exposures. This may be useful when considering the ability of a less liquid market to absorb asset sales, were they to occur concurrently in *schemes* operated by an *authorised fund manager*. Such an approach may be particularly pertinent when *schemes* operated by an *authorised fund manager* own a material level of assets in a given market.
		(2)	Aggregation of liquidity stress testing may allow an *authorised fund manager* to better ascertain the liquidation cost or time to liquidity of each *investment*, by considering the trade size, stressed market conditions and *counterparty risk*.
	The role of depositaries		
6 Annex 5.3.57	G	(1)	A *depositary* should set up appropriate verification procedures to check that an *authorised fund manager* has in place documented procedures for its liquidity stress testing programme. One way of verifying that liquidity stress testing is in place and carried out is to confirm that the risk management process for the *scheme* provides for an *authorised fund manager* to carry out liquidity stress testing on a *scheme.*
		(2)	The verification procedures do not require the *depositary* to assess the adequacy of the liquidity stress testing.
6 Annex 5.3.58	G	*Depositaries* of both *UCITS schemes* and *non-UCITS retail schemes* are required to implement procedures to verify that a *scheme* is acting in compliance with regulatory requirements.	
6 Annex 5.3.59	G	(1)	Where the *depositary* is not satisfied that liquidity stress testing is in place, it should take action as per any other evidence of a potential breach of rules by an *authorised fund manager*.
		(2)	The appropriate action at (1) may be for a *depositary* to inform (or require an *authorised fund manager* to inform) the *FCA* of the *authorised fund manager's* failure to comply with applicable rules.
6 Annex 5.3.60	G	The *depositary* does not need to replicate or challenge the liquidity stress testing undertaken by an *authorised fund manager*.	

Amend the following as shown.

[*Editor's note*: the proposed amendments to COLL TP 1 below take into account the amendments proposed in the consultation paper 'Progressing Fund Tokenisation' (CP25/28) as if they were made.]

TP 1 Transitional Provisions

TP 1.1

(1)	(2) Material to which the transitional provision applies	(3)	(4) Transitional provision	(5) Transitional provision: dates in force	(6) Handbook provision: coming into force
…					
	Amendments made by the Collective Investment Schemes Sourcebook (Liquidity Management) Instrument 2026				
68	*COLL* 4.2.5R(18)	R	An *authorised fund manager* is not required to comply with the *rule* specified in column (2) until the earlier of: (1) the date on which the *prospectus* is next updated; or (2) [12 months from the commencement date].	From [*Editor's note*: insert the commencement date of this instrument] until [12 months afterwards]	[*Editor's note*: insert the commencement date of this instrument]
69	*COLL* 5.2.8R(3)(e), *COLL* 5.6.5R(1)(b) and *COLL* 5.2.20R(2)(a)	R	(1) This *rule* applies in relation to any recently issued *transferable security* which, immediately before [*Editor's note*: insert the commencement date of this instrument], fell within the *rules* in column (2) and was held in the *scheme property* of a *UCITS scheme* or a *non-UCITS retail scheme*. (2) The *authorised fund manager* may continue to apply the provisions in column (2) as they applied immediately before [*Editor's note*: insert the commencement date of this instrument], until no later	From [*Editor's note*: insert the commencement date of this instrument until [12 months afterwards]	[*Editor's note*: insert the commencement date of this instrument]

				than one year after issue of the *transferable security*.		

Annex C

Amendments to the Investment Funds sourcebook (FUND)

In this Annex, underlining indicates new text and striking through indicates deleted text.

3 Requirements for alternative investment fund managers

…

3.6 Liquidity

…

Liquidity systems and procedures

3.6.3	R	…
3.6.3A	G	The *AIFM* of a *non-UCITS retail scheme* should, in meeting the requirements of *FUND* 3.6.3R, take into account the guidance at *COLL* 6 Annex 5 (Guidance notes on liquidity stress testing in UCITS schemes and non-UCITS retail schemes).

…

3.7 Risk Management

…

Risk management systems

…

3.7.5A	G	…
3.7.5AB	G	The *AIFM* of a *non-UCITS retail scheme* should, in meeting the requirements of *FUND* 3.7.5R, take into account the guidance at *COLL* 6 Annex 4 (Guidance notes on liquidity risk management).

…

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