TECHNICAL GUIDE 1/2022 ON THE MANAGEMENT AND CONTROL OF THE LIQUIDITY OF COLLECTIVE INVESTMENT SCHEMES (CISs)

27 January 2022

CONTENTS

Introduction

Article 23 of Spanish Law 35/2003 (hereinafter, CISL) establishes that liquidity is one of the principles that must govern the operation of CISs, taking into account their nature, the type of investor and the assets in which they invest.

In order to comply with this principle, Article 53(1) of Regulation 1082/2012 implementing the CISL (hereinafter, CISR), requires management companies (hereinafter, CISMCs) to ensure that CISs have a sufficient level of assets that: can be sold quickly and at a price close to that at which they were valued prior to the sale; allows, under both normal and exceptional liquidity conditions, to meet redemptions and guarantee the settlement of transactions undertaken; is consistent with the CIS's overall liquidity management policy, which must be assessed using stress tests.

In addition, Article 53(4) of the CISR and rules 3 and 4[1] of CNMV Circular 6/2009 stipulate that the CISMC must have in place internal systems for monitoring the depth of the market for the securities in which it invests (considering regular trading and the volume invested), to ensure orderly settlement of the positions of the CIS managed through the normal trading mechanisms, in order to guarantee that its capacity to meet requests for redemption of units or sale of shares is not diminished, and to respect, at all times, fairness among investors.

Therefore, management companies must minimise the risk of harming investors by selling assets at penalised prices (known as fire sales), and above all, avoid generating conflicts of interest [2] while respecting fairness among investors, by establishing in their procedures how they will comply, with a reasonable margin, the proportion between liquid and illiquid assets (known as the slicing approach).

Rule 4[3] of CNMV Circular 6/2009 entrusts the risk management unit with identifying, assessing and quantifying the risks affecting the CIS, including liquidity risk, and for this purpose it must carry out the appropriate analyses and checks. In this respect, Article 148(4) of the CISR states that, taking into account the nature of the investment, the CISMC shall make the necessary forecasts and analyses of the contribution of the investment to the composition, liquidity and risk return profile prior to making the investment. Such analyses shall be carried out on the basis of reliable and up-to-date information only and shall consider both quantitative and qualitative aspects.

1 Indent (iii) of letter (d) of paragraph 4 of Rule 3 and Indent (vii) of letter (b) of paragraph 1 of Rule 4 of CNMV Circular 6/2009.

2 The obligation of the CISMC to avoid any type of conflicts of interest is set out in various articles of the CISL and the CISR, inter alia, Article 43(1)(j) and Article 46(2)(b) CISL; Article 144 and Article 106(1)(d) CISR.

3 Indents (i) and (ii) of letter (b) of paragraph 1 of Rule 4 of CNMV Circular 6/2009.

Rule 4 of Circular 6/2009 also establishes certain criteria and guidelines for the assessment and analysis of liquidity risk, both at the level of the managed CISs and at the level of each financial instrument, among others: quantitative and qualitative factors on the asset side (trading volumes and frequency, trading price trends, estimated asset sale periods, etc.) and on the liability side of the CIS (structure of unitholders, redemption patterns, etc.); that the assessment is not only carried out individually for each CIS but also globally for all the CISs managed, including any other port folios managed by the CISMC; that simulations of limit situations or extreme cases are carried out.

Furthermore, CISMCs must take into account all the tools made available under the regulations for the liquidity management of CISs, including notice periods (Article 78(6) of the CISR), delaying the payment of redemptions to three days (Article 78(5) of the CISR), temporary borrowing (Article 71 of the CISR), subscriptions and partial redemptions (Article 78(7) of the CISR), the creation of side-pockets (Articles 28(a) of the CISL and 75 of the CISR), and lastly, the suspension of the CIS (Article 4(10) of the CISR).

In addition, we should not forget the close relationship between liquidity and asset valuation, and therefore, the need for CISMCs to have pricing models and valuation systems in place which, being equitable, correct and transparent, allow them to act in the interest of their unit holders or shareholders (Article 147(b) of the CISR).

To this end, they must have in place regular controls to ensure that the valuations applied to assets are at all times representative, and thus adequately reflect the price levels at which transactions could be executed in both normal and exceptional market circumstances. Consideration should also be given to the possible use, where necessary, of anti-dilutive tools aimed at passing on to the originating unitholders the costs of the purchase or sale transaction, thus avoiding conflicts of interest between subscribing or redeeming unitholders and those who subscribed previously (in the case of net subscriptions) or those who remain (in situations of net redemptions).

The CNMV has been taking a special supervisory interest in liquidity management for years and, as a result, has been transmitting best practices to supervised entities and has issued guidelines[4] and recommendations on the aspects that should be covered by procedures and analysis in this area.

---

[4] Worthy of note are the guidelines included in Questions 61bis and 75 bis of the document "Questions and answers on CISs, Venture Capital Firms and other closed-ended collective investment vehicles" published on the CNMV's website in November 2018.

[5] "*Guidelines on Liquidity Stress Testing (LST) in UCITS and AIFs (September 2019)*", and also "*Economic Report on Stress Simulation for Investment Funds (September 2019)*".

[6] IOSCO's *Recommendations on Liquidity Risk Management for Collective Investment Schemes* (February 2018).

[7] *Recommendation of the European Systemic Risk Board on liquidity risks in investment funds (ESRB/2020/4)* and *ESMA Report 34-39-1119* published on 20 November 2020.

[8] Financial Stability Board (FSB)'s *Recommendations to Address Structural Vulnerabilities from Asset Management Activities* .

Likewise, the proper liquidity management of CISs has been the subject of interest from various European and international bodies which have published reports and guidelines on liquidity risk management (among others): ESMA[5], IOSCO[6], ESRB[7], FSB[8] and AMIC/EFAMA[9]), and, in this area, the implementation in 2020 of supervisory convergence actions coordinated by ESMA in relation to the liquidity of EU passported funds (UCITS) is particularly noteworthy[10].

For all these reasons, a Technical Guide is considered necessary to unify in a single document all the relevant supervisory criteria related to the management and control of the liquidity of CISs, taking into account the results of recent actions carried out at national and European level.

This Technical Guide is addressed to supervised entities and contains the criteria, practices, methodologies and procedures that the CNMV considers appropriate for compliance with the applicable regulations in the area of CIS liquidity control and management, as well as the criteria it will follow in the exercise of its supervisory function. Any entities that deviate from these criteria must in any case be able to demonstrate that they duly comply with the legal obligations and explain the reasons for deviating from the CNMV's criteria.

In accordance with Article 21(3) of the Recast Text of the Spanish Securities Market Act, approved by Spanish Royal Legislative Decree 4/2015, of 23 October, the CNMV approved on 27 January, following a report from its Advisory Committee, this Technical Guide.

---

[9] *Managing fund liquidity risk in Europe. Proposals for further improvements (6 January 2020).*

[10] The conclusions were published via *ESMA's Public Statement of 24 March 2021*.

One. Scope

1. This Technical Guide refers to the transactions carried out by CISMCs for CISs, both directly and by delegation of third parties, and to investment schemes that have not entrusted their management to a management company, with regard to the management and control of liquidity.

Two. Liquidity management procedures

2. CISMCs must establish a procedure to enable them to adequately manage and control the liquidity risk of CISs, with the aim of avoiding harm to and conflicts of interest among investors.

3. The procedure shall expressly provide for:

   a) The analyses and limits established in the design phase of each CIS, and the checks to be carried out prior to investments (see section 3 of this Guide).

   b) The controls and analyses necessary to ensure appropriate alignment between the liquidity profile of the assets and liabilities of each CIS (detailed in section 4 of the Guide).

   To this end, the procedure shall expressly provide how the proportion between liquid and illiquid assets will be maintained, within a reasonable margin, and the measures that shall be taken to avoid harm to investors, inter alia, through forced sales of assets (known as fire sales).

   c) The tools that may be used for appropriate management of the liquidity of CISs (section 5 of the Guide).

   d) The roles assumed by the different areas of the management company, the involvement of the Board of Directors and further analyses relating to the delegation of tasks (see section 6 of the Guide).

Three. CIS design phase and pre-investment analysis

4. At the design stage of the CIS, the procedure shall set out the analyses to be carried out in which, taking into account the CIS's investment and risk policy, the types of assets and markets in which it may invest, the size of its assets, and the characteristics of its target investors, the need to establish the following, inter alia, is assessed:

   - A frequency of the net asset value lower than daily.

   - Notice periods in the prospectus.

- Discounts in favour of the fund on redemptions.

- A maximum limit on assets that can be raised.

These analyses are more relevant in the case of CIS that might invest mainly in asset classes that generally have lower levels of liquidity (e.g., equities of small companies or small caps; fixed income from emerging countries, or that which is rated below investment grade, also known as "high yield").

5. Taking into account the characteristics of CISs and the nature of the assets in which they may invest, the procedure shall establish internal exposure limits or thresholds according to the different levels of liquidity of the assets, applying prudent criteria, in particular for those assets that have been rated with the lowest levels of liquidity.

   Other limits may also be assessed on a case-by-case basis, such as maximum loss levels in stressed market circumstances, as well as specific requirements on certain issuers or issues, especially those of a small size (e.g., maximum investment volumes on total outstanding debt and/or equity).

6. With regard to the liquidity analyses that the CISMC must carry out prior to investments (as established in Article 148(4) of the CISR and Rule 4[11] of CNMV Circular 6/2009):

   a) Simplified procedures may be applied for certain investments, provided they are adequately justified taking into account the characteristics of the assets and the overall risk profile of the CIS.

   b) For assets to which a simplified procedure does not apply, liquidity analyses similar to those carried out on a recurring basis for the assets held by the CIS shall be carried out in accordance with the terms set out in section 4 of this Guide.

      It is particularly important that these analyses are carried out exhaustively, among other cases, when investing in new types of investments with greater potential liquidity risk (high yield, small caps, securitisations, subordinated debt, etc.), or in assets which by their nature have low levels of liquidity, mainly those regulated under Article 48(1)(j) of the CISR.

7. The results of the analyses carried out in the design phase of the CIS, as well as those carried out prior to the investments, must be adequately documented.

[11] Indents (ii) and (vii) of letter b) of paragraph 1 or rule 4 of CNMV Circular 6/2009.

Four. Liquidity analyses and controls

8. The CISMC shall define in its procedures the analyses and controls to be carried out on both the assets and liabilities of the CIS (Rule 4 of CNMV Circular 6/2009), and, among other information, shall include the methodology for determining the liquidity ratios of the financial instruments, the estimated time horizons for sale (and, where applicable, the costs of liquidating the assets), as well as the scenarios for redemptions and other payment obligations, and the stress tests and back-testing. Such methodologies must be consistent and defined on the basis of prudent criteria.

9. In determining liquidity ratios, time horizons, where appropriate, liquidation costs for each instrument, the methodology applied by the CISMC may take into account:

   a) For fixed-income assets: information on the levels of bid/ask spreads, the quality of quotations (analysing the number of financial intermediaries offering counterparties and the volumes offered), asset type and seniority levels, outstanding amounts of the issue (and what the investment will represent of these amounts), credit quality of the issuer/issue, duration, maturity, size of the issuer and total debt issued.

   b) For equity assets: trading volume and frequency, bid/ask spread levels and their evolution, issuer size and market capitalisation, outstanding capital, free float (and what the investment will represent in relation to these parameters), shareholding structure (and possible concentration risks in a small number of investors).

   For volume estimates, recent data shall be used and, unless there are justified reasons, shall be for periods of between three and six months. It is also considered good practice to establish an estimation of the maximum percentage of the average daily trading at which the asset could be sold without affecting its price. Finally, provided that its use is adequately justified and verifiable, the existence of trading other than that of regulated markets or multilateral trading systems, among others, block trading, may be taken into account to determine the liquidity level of the asset.

   c) For derivatives, inter alia, the liquidity of the underlying, the levels of bid/ask spreads, the volume traded and the open interest. For these instruments, the margins (in the case of futures, forwards, etc.), the premium or market value (in financial options) and the guarantees will be taken as a reference.

   d) For investments in other CISs, in addition to taking into account their liquidity frequency, an appropriate due diligence process should be carried out to identify any other possible restrictions on or limitations to redemption (e.g., notice periods and limits on a certain date or dates), and exposures held in assets which may have reduced liquidity levels, or which could potentially face a higher liquidity risk (e.g., high yield debt, small caps, unlisted assets, etc.). Potential liquidity impacts resulting from redemption requests in underlying CISs in which a high percentage of their assets are held will also be assessed.

e) In all the asset categories referred to above, for the estimation of time horizons, the normal settlement periods of transactions shall be taken into account. Additionally, the analyses must be carried out on an aggregate basis, i.e., taking into account the positions held by all CISs, including any other portfolios managed by the CISMC.

f) The information used shall be reviewed to ensure that it is correct and up to date at all times. To this end, the entity must have controls in place (for atypical variations, comparison with other sources, backtesting, etc.) to detect shortcomings that may arise in the data download or capture processes, as well as errors or inconsistencies in the information obtained, especially in those cases in which there is overreliance on the use of a data provider.

10. With regard to the liabilities of the CIS, the CISMC shall define as many scenarios of current and future payment obligations as possible, taking into account:

    a) Not only information on historical developments but also theoretical assumptions, which, under conservative criteria, the CIS could undergo.

    b) The structure and degree of concentration of certain investors. To do this, the best efforts will be made to detect possible "decision-making units"[12] and information about global accounts.

    c) The possibility of applying certain liquidity management tools, such as notice periods, the possibility to address redemptions in three days, or the possibility to use temporary borrowing, under the terms set out in section five of this Guide.

    d) In addition to redemptions, account should be taken of any other transactions that could give rise to credit balances or payment obligations that could materially affect the liquidity of the CIS, such as, inter alia, those affecting the levels of collateral required by the market in derivative transactions (known as margin calls).

11. In relation to stress testing, stressed asset and liability scenarios must be combined, in which the following considerations should be highlighted:

[12] Decision-making unit" means the aggregate positions of CISs and portfolios managed by the CISMC, clients managed by third parties and investing in the CISMC's CISs under a discretionary portfolio management contract, or clients linked to the CISMC's adviser as set out in its prospectus.

a) In relation to the assets of the CIS, for the estimation of the costs and the time horizons for the liquidation of the positions, stressed scenarios of widening bid/ask spreads, reduction in trading volumes, and downgrades in credit ratings, among others, shall be established, taking into account the market situation under extraordinary events or developments as well as under hypothetical scenarios. Additionally, in the case of relevant exposures in other CISs, the impact of such events and scenarios and the consequent risk of suspension of such positions should be analysed.

b) In relation to the liabilities of the CIS, taking into account its structure and the concentration of investors, simulations of: redemptions by several significant unitholders or "decision units", of historical information on the highest outflows over short periods of time, and of hypothetical scenarios based on conservative criteria must be carried out. In such scenarios, any other payment obligations that may arise from the operations of the CIS must also be stressed.

c) Reverse stress testing could be done if the management company considers it appropriate taking into account the characteristics of the CIS. In the reverse stress testing the CIS starts by identifying a very serious liquidity situation (in which the activation of an exception tool, such as a temporary suspension, has also been necessary). The circumstances that could trigger such situation are analysed, inter alia, due to holding certain weightings in illiquid assets or due to certain investor movements or exceptional market events.

Five. Tools for liquidity management

12. The procedure must cover, in as much detail as possible, the circumstances under which the following measures and tools allowed by the regulations to adequately manage the liquidity of CISs would be applicable, and that the management company will adopt in the manner it deems most advisable in the exclusive interest of the CIS:

a) The notice periods as set out in Article 78(6) of the CISR. In this respect, reimbursement transactions adopted under the same "decision-making unit" [13] must be taken into account. Provision must also be made for the possibility for the CISMC to request, for reasons of stability and integrity of the financial system, authorisation to apply the provisions of Article 71 septies (7)(b) of the CISL, for the purpose of requiring prior notice of redemptions without being subject to the time and

[13] Decision-making unit" means the aggregate positions of CISs and portfolios managed by the CISMC, clients managed by third parties and investing in the CISMC's CISs under a discretionary portfolio management contract, or clients linked to the CISMC's adviser as set out in its prospectus

minimum amount requirements laid down, and without requiring prior amendment of its prospectus.

b) Payment of the redemptions within three and exceptionally within five days (Article 78(5) CISR).

c) Temporary borrowing as set out in Article 71 of the CISR. In this respect, it must be demonstrated that there is no relevant harm or conflict of interest arising from the financing costs, if any, that could be passed on to the CIS.

d) Subscriptions and partial redemptions (Article 78(7) of the CISR), the constitution of side-pockets (Articles 28 bis of the CISL and 75 of the CISR), and lastly, the suspension of the CIS (Article 4(10) of the CISR).

13. The procedure must also provide for the use of anti-dilution tools aimed at passing on the costs of the purchase or sale transaction to the unitholders who originate them, thus avoiding conflicts of interest between subscribing or redeeming unitholders and those who subscribed previously (in the case of net subscriptions) or those who remain (in situations of net redemptions). Taking into account the characteristics of the CIS, the management company could apply: bid or ask prices on each of the assets held by the CIS, and swing pricing, as a mechanism characterised by an adjustment (or swing factor) to the net asset value. For their implementation, the following must be taken into account:

a) That depending on the investment policy, types of assets, the movements of investors and the costs of the purchase and sale transactions of the CIS, certain daily impact and/or net inflow or outflow volume thresholds may be established which, if exceeded, would require their activation. However, it is particularly important to analyse and monitor the cumulative impact that could be caused to unitholders who remain in the CIS (or were previously in the case of subscriptions) as a result of not activating these adjustments, and also to establish a threshold of cumulative impact (at least in monthly terms) that is controlled, and which, if exceeded, also entails the activation of these anti-dilution tools. This cumulative impact threshold must be defined conservatively and may vary depending on the CIS's investment and risk policy.

b) That controls have been defined to avoid any conflict of interest that may arise in the application of these tools, inter alia, by having information on the movements that are going to occur in the CIS and that, therefore, parties related to the CISMC may request subscriptions when a negative adjustment is applied (due to high net redemptions) or redemptions in the opposite case (if the adjustment is positive due to net subscriptions).

c) That they are sufficiently flexible to be able to apply additional adjustments, if necessary, to reflect exceptional market situations where the prices at which transactions could be executed differ significantly from the prices used for their valuation. To estimate this adjustment, the discounts required by the market may be extrapolated to a representative sample of assets, which in the case of fixed income may be done by type of asset (public or private debt, sector, rating, priority level, etc.), and in the case of equities, based on information from transactions carried out or observed in the market for similar volumes (especially through block transactions).

d) With respect to swing pricing, the procedure shall include, among others, the following: (i) objective requirements for its application; (ii) methodology and sources of information used; (iii) controls carried out and their periodicity; (iv) areas involved (management, risk, administration, etc.) and how their participation will be organised; v) keeping a record of the days on which the adjustment to the net asset value was made or should have been made, and supporting documentation of the decisions adopted (whether or not the adjustment factor was finally applied); vi) that all relevant implicit (bid/ask spreads) and explicit costs (settlement, brokerage, taxes, etc.) are taken into account, and that they are properly updated and calibrated with respect to the market at all times.

14. Finally, the CISMC must prove that the use of the tools described above does not generate conflicts of interest, and that appropriate tests are carried out to ensure that they can be activated at the time when it is necessary in accordance with its procedures.

Six: Other considerations of particular relevance

15. The procedure must reflect the different areas involved in liquidity risk management, specifically those responsible for the risk function, compliance, and internal audit, detailing, in each case, their responsibilities and the analyses and controls to be carried out. In addition, an effective system of communication between these areas and the management bodies (in particular with the Board of Directors) must be defined.

16. The frequency with which liquidity analyses will be performed by the risk management area will also be established. Such frequency shall be determined on the basis of the characteristics of the CIS and the market circumstances prevailing at any given time. Among other factors, the liquidity frequency of the net asset value, investment policy and strategies, redemption trends, types and concentration of investors will be taken into account.

    In any case, in those schemes that have a significant exposure to assets with low levels of liquidity or that could experience a high turnover of investors, recurrent analyses must be performed at least once a month and stress tests on a quarterly basis, provided that there are no exceptional market situations that require continuous monitoring of the situation.

For other schemes, depending on their characteristics, a frequency shall be established which may not be less than quarterly in the case of recurrent analyses, and annually for stress tests.

17. Pursuant to Rule 2 of CNMV Circular 6/2009, the Board of Directors of the CISMC must be directly involved and participate in the definition and supervision of these procedures and controls that must be established to adequately manage the liquidity risk of the CISs.

18. To this end, it is particularly important that the documentation to be submitted at least quarterly to the Board of Directors by the unit in charge of the risk function provides detailed information on the analyses performed, the results obtained, and the conclusions reached.

    In addition, circumstances will be determined which, due to their seriousness or relevance, must be reported immediately so that they can be duly analysed and, where appropriate, the necessary preventive measures can be adopted to protect the interests of investors, among others: relevant exceedances of any of the limits or thresholds indicated in point 6 of section Three of this Guide, identification of mismatches between the settlement of assets and the obligations to pay liabilities (in both normal and exceptional circumstances), as well as any other type of weakness or problem that could significantly affect the liquidity risk management of the CISs.

19. In cases where the management activity is delegated, in addition to applying the procedures described above, controls must be established to detect investment decisions that could significantly affect the liquidity levels established for each CIS, as well as possible conflicts of interest or harm to unitholders (due to fire sales).

    In addition, a global analysis must be carried out in which, with the publicly available information, it is detected whether other CISs or portfolios managed by the delegated entity (pension schemes, client model portfolios, etc.) could hold positions in the assets with the lowest levels of liquidity.

    Finally, if the calculation of the net asset value is delegated, the appropriate use of anti-dilutive tools (bid/ask prices or swing pricing) and the establishment by the delegated entity of adequate controls to analyse the representativeness of the valuations applied to the assets must be verified.