Uniquely Canadian regulatory expectations for investment fund liquidity risk management

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On September 18, 2020, the Canadian Securities Administrators (CSA) released CSA Staff Notice 81-333 *Guidance on Effective Liquidity Risk Management for Investment Funds*. The Notice provides guidance for investment fund managers (IFMs) and portfolio managers (PMs) on the CSA's expectations that those firms develop and maintain effective liquidity risk management (LRM) frameworks in respect of the investment funds they manage. An LRM framework supports the ability of investment funds to satisfy redemption requests without significantly diluting remaining fund investors and maintain the funds' liquidity profiles. The guidance provided in the Notice is aimed at IFMs of investment funds that are subject to National Instrument 81-102 *Investment Funds*, although the CSA note that many of the LRM practices and examples contained in the Notice may also be relevant for other types of investment funds.

Background

Through the Notice, the CSA respond to international initiatives over a number of years relating to LRM practices from the Financial Stability Board (FSB) and the International Organization of Securities Commissions (IOSCO)[1]. These initiatives took into account lessons learned from the financial crisis of 2007 with an initial focus on LRM of open-ended collective investment schemes. IOSCO's 2018 *Recommendations for Liquidity Risk Management for Collective Investment Schemes - Final Report*, prompted the two Canadian participants in IOSCO – L'Autorité des marchés financiers (AMF) and the Ontario Securities Commission (OSC) – to seek input from various Canadian market participants in responding to IOSCO's recommendations and developing the principles set out in the Notice[2].

No "one size fits all"

Liquidity risk refers to "the risk that a fund is unable to satisfy redemption requests without having a material impact on the remaining securityholders of a fund" (ie. the potential mismatch between the liquidity of underlying portfolio assets of the investment fund and the redemption terms and conditions afforded to fund investors). The CSA emphasize that materiality varies between funds and that different approaches to

effectively manage liquidity risk can be used according to a fund's characteristics such as size, structure, investment objectives and strategies and investor base. The CSA expressly state that the guidance does not suggest or endorse a "one size fits all" approach to LRM, given that each investment fund has its own unique characteristics, including liquidity risk. This will be welcome news particularly for smaller managers.

CSA expectations and existing regulatory requirements

While the Notice is intended as guidance for IFMs and PMs, it is clear from the language used that the CSA's expectations will be used as a reference point in their future compliance reviews of LRM policies and procedures, as well as fund disclosure.

The CSA expects each IFM to establish and maintain an effective LRM framework that is consistent with its statutory standard of care, as well as its obligations, as applicable, under National Instrument 31-103 and NI 81-102. By linking a fund's liquidity risk with the "business of the fund" and the internal control and compliance requirements contained in NI 31-103, the CSA highlight that registrant firms have an obligation to establish LRM controls and supervision sufficient to manage the liquidity risks associated with their funds.

The Notice reiterates the CSA's views that managers of investment funds subject to NI 81-102 must establish an effective LRM policy that considers the liquidity of the types of assets in which the investment fund will be invested and the fund's obligations and other liabilities. IFMs should regularly measure, monitor and manage the liquidity of the investment fund's underlying portfolio assets, keeping in mind the time to liquidate each portfolio asset, the price at which the asset may be sold and the pattern of redemption requests.[3]

LRM framework

The CSA highlight five important key areas for an effective LRM framework:

1. Strong and effective governance

IFMs should assess whether an existing governance body or new committee needs to be established in order to provide adequate oversight of the LRM function. Such assessment should consider whether new or enhanced reporting and other compliance mechanisms need to be implemented to ensure the necessary information is being monitored and shared with relevant parties.

The CSA set out potential responsibilities of such an oversight committee, including reporting and escalation procedures, valuation, conflicts of interest, ongoing review of LRM policies and procedures as well as establishing stress testing and reviewing the results of such stress testing.

2. Creation and ongoing maintenance of LRM procedures

An LRM process should begin with the design phase of investment products to ensure alignment of redemption terms and investment strategy taking into consideration the lifecycle of the fund. An effective LRM process may include the regular assessment of the liquidity profile of the fund's assets and liabilities taking into consideration current market conditions, redemption activity, and investor behaviour and periodic communication and review by senior management and/or relevant personnel. A number of principles and practical implementation strategies are set out in the Notice, including:

- Aligning investment objectives, strategies and the redemption policy of a fund with the liquidity profile of its underlying portfolio assets and redemption demands of the investor. For example, in cases where the fund holds substantial amounts of thinly traded securities, or whose securities have longer settlement periods, an IFM could elect to have the fund offer less frequent redemption opportunities to investors;
- Performing active, ongoing portfolio monitoring using qualitative and quantitative metrics to ensure adequate levels of liquidity exist to meet redemption needs and other obligations; and
- Setting internal liquidity thresholds and targets that management can use to assess the liquidity profile of a fund and make any necessary adjustments.

3. Stress testing

The CSA explain that stress testing may be an effective aspect of an IFM's LRM process, given that it will enable an IFM to assess and respond to liquidity risks. Some of the key factors for stress testing include:

- Identification of risks including market and redemption risks such as market stress affecting a class or subclass of asset, interest rate risk, geopolitical risk;
- Scenario analyses that are diverse and reflect material risks relevant to the fund. IFMs may consider factors such as a downgrade of the credit rating of an underlying portfolio asset or of the related issuer, changes in interest rates, widening of bid-ask spreads and economic shocks;
- Historical stress testing that include factors such as the comparison of historical cash flows with industry-wide cash flows for funds of similar size and strategy, or the redemption activity of the largest investor or group of investors; and
- Hypothetical stress testing which attempts to measure the potential impact of an event that has not yet occurred, such as interest rate changes or the potential for counterparty default.

Frequency of stress testing will depend on the specific attributes of a fund such as fund size, redemption frequency and investor base. It will be important to document and analyse testing results and communicate the results to the committee overseeing liquidity risk.

4. Disclosure of liquidity risks

The CSA consider that disclosure of material liquidity risk is part of full, true and plain disclosure required to be made to investors in an investment fund. The existing disclosure requirements of National Instrument 81-101 provide for specified mandated disclosure of liquidity risk for public investment funds, including the risk that redemptions may be suspended and the specific risks associated with redemptions by holders of

large positions in the funds. The CSA expect that LRM governance matters relating to the funds will be included in the prospectus disclosure and if an IFM does not have written policies and procedures around LRM, this fact should then be disclosed to investors. The Notice gives examples of the CSA's expectations for such disclosure that IFMs should review in connection with prospectus filings and renewals.

Liquidity risks should also be addressed in a fund's continuous disclosure documents, including the management reports of fund performance mandated by National Instrument 81-106. This would include disclosure of any liquidity challenge during the period and how those challenges were addressed, along with changes in risk level of a fund due to market conditions, significant redemptions or liquidity of underlying portfolio assets.

5. Use of LRM tools to manage potential and actual liquidity issues

Any use of LRM tools (such as suspension of redemptions and borrowing) to aid in the liquidity management of a fund are subject to certain overarching principles:

- The use of a mechanism that affects redemption rights is only justified in open-ended funds in exceptional circumstances. Such circumstances are rare, such as where a fair and robust valuation of the assets in which the fund is invested is difficult or impossible to carry out, or where redemption demands are so large/exceptional that liquidity cannot be raised in the timeframe required to meet the demands.
- The use of extraordinary LRM tools must be in the best interest of the fund investors collectively. A fund should only use such tools when it is in the best interest of investors and when the fair and equal treatment of incoming, ongoing and outgoing investors is maintained.

The CSA guidance contained in the Notice provides a uniquely Canadian flexible response to IOSCO's 2018 recommendations for liquidity risk management of collective investment schemes, among other international developments. The Notice will serve as a useful checklist for IFMs and PMs to establish and evaluate their LRM polices and procedures having regard to the nature of their funds. The guidance should be applied to investment funds that are subject to NI 81-102; however, we expect the CSA will also consider that managers of private pooled funds and other commingled vehicles should apply these principles.

We have closely followed the various developments regarding liquidity risk management for investment funds over the years and would be pleased to discuss the implications of the CSA guidance in the Notice on your management of your investment funds. Please contact any of the authors below or your usual BLG lawyer for assistance and responses to any questions you may have.

[1] IOSCO, *Principles of Liquidity Risk Management for Collective Investment Schemes*, Final Report, Report of the Board of IOSCO, March 2013. FSB, *Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities*, 2017. IOSCO, *Recommendations for Liquidity Risk Management for*

Collective Investment Schemes – Final Report, 2018; and IOSCO, *Open-Ended Fund Liquidity and Risk Management – Good Practices and Issues for Consideration*, 2018.

[2] Including a Task Force struck by The Investment Funds Institute of Canada to survey its mutual fund manager members between October and December, 2018. The mandate of the Task Force was to identify questions that would survey investment fund managers on their policies and procedures for managing portfolio liquidity risk.

[3] See also OSC Staff Notice 81-727 *Report on Staff's Continuous Disclosure Review of Mutual Fund Practices Relating to Portfolio Liquidity*.

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