Canadian Securities Administrators — Autorités canadiennes en valeurs mobilières

CSA Staff Notice 81-333

Guidance on Effective Liquidity Risk Management for Investment Funds

September 18, 2020

A. Introduction

The Purpose of this CSA Staff Notice (the **Notice**) is to provide guidance to investment fund managers (**IFMs**) on developing and maintaining an effective liquidity risk management (**LRM**) framework for investment funds. While this guidance is aimed at investment funds that are subject to NI 81-102 *Investment Funds* (**NI 81-102**), many of the LRM practices and examples outlined below may also be relevant for other investment funds when IFMs consider how to effectively manage their funds' specific liquidity risks.

The guidance provided in this Notice is based on existing securities regulatory requirements and does not create any new legal requirements or modify existing ones. Further, the guidance outlined below is meant to be flexible and scalable; it is not meant to suggest a "one-size fits all" approach since LRM is inherently fund-specific and multi-dimensional. IFMs may tailor their liquidity practices to manage and mitigate material liquidity risks specific to each fund's unique characteristics.

For purposes of this Notice, 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. A fund must be able to sell the underlying portfolio assets within a reasonable amount of time, in an orderly manner to satisfy redemption requests. If a fund does not manage liquidity risk properly, there could be adverse outcomes for the fund and its investors.

Concerns may arise where there is a potential mismatch between the liquidity of the underlying portfolio assets of investment funds and the redemption terms and conditions offered to investors. The management of potential liquidity mismatch is a key focus for regulators. Internationally, the Financial Stability Board (**FSB**) has expressed concerns over certain structural vulnerabilities from asset management activities and specifically identified the liquidity mismatch as a potential source of systemic risk.[1] In Canada, the Bank of Canada (**BoC**) recently noted funds' liquidity/redemptions mismatch as a potential area of structural concern,[2] though they also noted that asset managers appear to be taking

[1] FSB "*Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities*" https://www.fsb.org/2017/01/policy-recommendations-to-address-structural-vulnerabilities-from-asset-management-activities/

[2] Bank of Canada "*2019 – Financial System Review*" https://www.bankofcanada.ca/wp-content/uploads/2019/05/Financial-System-Review%E2%80%942019-Bank-of-Canada.pdf

measures to mitigate the impact of a decline in liquidity on the financial system.[3]

Considering these global developments and heightened awareness around LRM in the asset management sector generally, staff of the Canadian Securities Administrators (**Staff** or **We**) are providing guidance in this Notice regarding effective LRM practices for investment funds. We encourage investment funds, IFMs and portfolio managers to review this Notice.

Purpose

This Notice:

- briefly summarizes certain key international securities regulatory developments and the Canadian securities regulatory framework in this area, and
- provides relevant and practical guidance for Canadian investment funds and their managers to support development and maintenance of a robust, effective LRM framework that considers normal and stressed market conditions.

Investment funds vary in terms of size, structure, investment objectives and strategies, investor base, underlying portfolio assets and other fund characteristics, all of which may impact the specific liquidity risks facing the fund. What may be considered a material liquidity risk for one fund, may not be material for another fund. Accordingly, there are different approaches to effectively manage liquidity risk, according to each fund's characteristics. The guidance provided in this Notice is not meant to suggest or endorse a "one size fits all" approach to LRM.

Any examples provided herein are for illustrative purposes only and not meant to be exhaustive of all potential scenarios or approaches to LRM.

B. Key international securities regulatory developments and the Canadian framework

International regulatory landscape

In recent years, both the FSB and the International Organization of Securities Commissions (**IOSCO**) have published policy recommendations and guidance pertaining to LRM in the asset management sector. In January 2017, the FSB published "*Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities*" (the **2017 FSB Policy Recommendations**).[4] As noted above, the 2017 FSB Policy Recommendations identified a "liquidity mismatch between fund investments and redemption terms and conditions…" as a potential source of structural vulnerability arising from asset management activities and asked IOSCO to review its existing guidance in this area and, as appropriate, enhance it.

[3] The BoC noted that:

> *Open-ended mutual funds that have large holdings of corporate bonds have grown significantly in the past decade and that such funds offer daily redemptions to investors but hold assets that may be difficult to sell on short notice. If many investors were to withdraw simultaneously, these funds might be forced to quickly sell bonds to honor their commitments, potentially decreasing liquidity in the bond market. A decrease in liquidity could have negative consequences for both bondholders and bond issuers, which could amplify the effect of an adverse shock on the financial system.*

The BoC also noted that asset managers are, however, aware that market liquidity may be less reliable than in the past and have indicated that they are altering their portfolio management strategies to prepare for periods of low liquidity, which should mitigate the impact of a decline in liquidity on the financial system.

[4] See footnote 2.

In February 2018, following an extensive public consultation exercise, IOSCO issued a report entitled "*Recommendations for Liquidity Risk Management for Collective Investment Schemes - Final Report"* (the **2018 IOSCO LRM Recommendations**).[5] The 2018 IOSCO LRM Recommendations emphasize that throughout the entire lifecycle of the fund, there should be an appropriate alignment between underlying portfolio assets and redemption terms. IOSCO noted that these recommendations are directed at preventing liquidity and redemption mismatches from arising in the first place, rather than just mitigating problems as they crystallize.

Domestic regulatory landscape

Under the Canadian securities regulatory regime, IFMs have a general statutory obligation to:

- exercise the powers and discharge the duties of their office honestly, in good faith and in the best interests of the investment fund, and
- exercise the degree of care, diligence and skill that a reasonably prudent person would exercise in the circumstances.[6]

(the **IFM Statutory Conduct Standard)**.

In exercising their duties under the IFM Statutory Conduct Standard, it is both in the best interest of the fund and prudent for IFMs to consider investor redemptions and fund liquidity when designing the fund's operation and managing the fund's assets.

Both NI 81-102 and NI 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* (**NI 31-103**) also contain provisions which are relevant to LRM and the roles and responsibilities of IFMs in managing liquidity risk.[7] As a fund's liquidity risk is a risk associated with the business of the fund, section 11.1 of NI 31-103 requires a registered firm to have policies and procedures, that establish a system of controls and supervision sufficient to address such risk. In addition, Part 3.3.1 of Companion Policy 81-102CP states that the CSA expects an IFM to 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. It also states our view that the 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 underlying portfolio asset, the price the asset may be sold at and the pattern of redemption requests.

Lastly, in Ontario, Ontario Securities Commission staff (**OSC Staff**) have conducted continuous disclosure reviews of fund practices relating to portfolio liquidity and have provided certain LRM guidance and recommendations based on staff's observations from these reviews.[8]

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[5] https://www.iosco.org/library/pubdocs/pdf/IOSCOPD590.pdf. The 2018 IOSCO LRM Recommendations were followed by a second Final Report entitled "*Open-ended Fund Liquidity and Risk Management – Good Practices and Issues for Consideration*", which provides a list of market best practices to address LRM (see: https://www.iosco.org/library/pubdocs/pdf/IOSCOPD591.pdf). IOSCO also issued a July 2019 statement on its 2018 IOSCO LRM Recommendations, noting why they provide a comprehensive framework for addressing liquidity risk (see: https://www.iosco.org/news/pdf/IOSCONEWS539.pdf).

[6] For example, see s.116 of the *Securities Act* (Ontario) (the OSA), s. 159.3 of the *Securities Act* (Quebec), s.125 of the *Securities Act* (British Columbia), s.54(3) of the *Securities Act* (New Brunswick), s. 33.1(1) of the *Securities Act* (Saskatchewan), and s.75.2(3) of the *Securities Act* (Alberta).

[7] See for example, s. 2.4 of NI 81-102 for restrictions concerning illiquid assets, s. 2.18 of NI 81-102 for money market funds and s.11.1 of NI 31-103 for compliance systems of registered firms.

[8] See OSC Staff Notice 81-727 *Report on Staff's Continuous Disclosure Review of Mutual Fund Practices Relating to Portfolio Liquidity* (**OSC SN 81-727**). This review was undertaken based on OSC Staff's observations that, while the mutual fund industry consists largely of funds focused on traditional asset classes, such as equities and investment grade debt, there was an increase in fund offerings with asset classes that may have higher liquidity risk. OSC SN 81-727 provided a summary of the results of the continuous disclosure review and also contained a number of recommendations based on OSC Staff's observations at that time.

C. Elements of an Effective LRM Framework

The LRM process forms a critical part of the broader total risk management process for investment funds. The following guidance is intended to identify key elements of an effective LRM framework and further discusses how each of these elements is relevant to developing and maintaining an effective LRM framework for investment funds.

A robust and effective LRM framework should include the following key areas (see also Figure 1):

- Strong and effective governance
- Creation and ongoing maintenance
- Stress testing
- Disclosure of liquidity risks
- Use of LRM tools to manage potential and actual liquidity issues

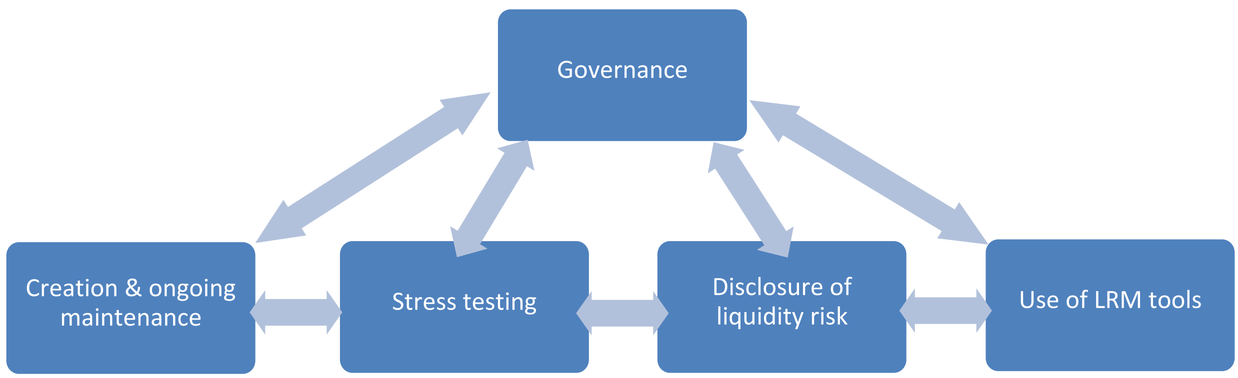

Figure 1.

1. *Strong and Effective Governance*

Figure 2.

Governance is an essential element for an effective LRM process and provides oversight of the liquidity management of a fund that is independent of the portfolio management function. Since securities legislation does not prescribe detailed requirements pertaining to all aspects of fund governance, in practice, IFMs have the discretion to determine effective LRM governance, which may include separate governance structures for purposes of general fund management and specific risk oversight.

In maintaining an effective LRM framework, an IFM's investment committee, governance committee or other group charged with risk oversight may be formed and have primary responsibility for dealing with material LRM matters. In fulfilling their oversight function, such committee should consider:

- the assessment, monitoring and review of liquidity risk within the LRM framework,
- the effectiveness of the policies and procedures relating to LRM controls, and
- the development and oversight of policies and procedures which set out escalation procedures in the event of a liquidity event.

IFMs should assess whether an existing governance body or new committee needs to be established to provide adequate oversight over the LRM function, independent of the portfolio management function and for the ongoing management and monitoring of liquidity.

The expertise of the committee members or other working group could be diverse across functions, such as product development, risk management, compliance, portfolio management and fund management.

While we understand that funds may vary in size, operations and organizational structure, the following examples reflect potential responsibilities of an oversight committee as it relates to LRM:

- establishing reporting and escalation procedures for material liquidity events, portfolio valuation issues and deficiencies in internal controls as they relate to LRM,
- considering those circumstances where a liquidity issue may cause a conflict of interest between the fund and the IFM, and whether such situations require escalation or other internal approvals,
- on-going review of LRM policies and procedures, and
- reviewing of all material exception reports for stress testing and working with the portfolio managers to ensure appropriate remedial steps have been taken.

In considering whether the funds they manage have a robust, effective and well-maintained LRM framework in place, IFMs may also need to:

- obtain and assess information from various sources across functions, and
- if not already in place, consider whether new or enhanced reporting and other compliance mechanisms need to be implemented to ensure that the necessary information is being shared with relevant parties within the IFM.

The collection and dissemination of relevant and timely liquidity information will enable IFMs and portfolio managers to better anticipate and deal with liquidity risks in a proactive and orderly manner.

2. Creation and Ongoing Maintenance

The CSA expect IFMs to have LRM processes, policies and procedures in place that are consistent with the IFM Statutory Conduct Standard which applies to them under local securities legislation,[9] as well as with their obligations as registered firms under NI 31-103 and the obligation of the funds under their management to comply with NI 81-102.[10]

A proper LRM process should begin with the design phase of products to ensure alignment of redemption terms and investment strategy, and from there will continue to take into consideration the lifecycle of the fund, recognizing that the fund's liquidity risk characteristics may change over time, and that LRM needs to remain effective in varied market conditions.

An effective LRM process may include:

- documented policies and procedures that address the fund's key liquidity risks, which could include a description of how these risks are identified, monitored and measured, and the techniques used to manage and mitigate these risks,

[9] See footnote 7.
[10] See CSA Consultation Paper 33-403 for further details.

- a regular assessment of the liquidity profile of the fund's assets and liabilities taking into consideration current market conditions, redemption activity, and investor behavior, and
- communication and review by senior management and/or relevant personnel on a periodic basis.

The following six principles, and related practical implementation strategies for each, support creating and maintaining an effective LRM framework (see also Figure 2):

1. ***Align the investment objectives, strategy, and redemption policy of the fund with the liquidity profile of the fund's underlying portfolio assets and the redemption demands of the investor base at the design stage and on an ongoing basis***.
    - Consider whether investments are aligned with redemption features and investor base of the fund throughout its lifecycle and monitored on a regular basis.
    - For example, if a fund holds a substantial amount of investments that are thinly traded, have longer clearing periods or are in emerging markets, the IFM may elect to offer less frequent redemptions.
2. ***Create and adhere to robust policies and procedures that integrate LRM considerations.***
    - An effective LRM framework includes comprehensive policies and procedures that fully integrate LRM into investment decisions, including portfolio trading activities.
    - Consider whether the stated policies and procedures are aligned with the liquidity profile of the fund and support the overall ability of the fund to meet investor redemption requests and its other obligations.
3. ***Perform active, ongoing portfolio monitoring using qualitative and quantitative metrics to ensure adequate levels of liquidity exist to meet redemption needs and other obligations. All relevant data should be used to actively manage liquidity risks.***
    - A fund may regularly review the composition of underlying portfolio assets, including cash and short-term securities with consideration of past redemption activity, distribution channels, investor base, fund performance, fund ownership, and any other special considerations (for example, changing market or other economic factors).
    - An effective liquidity assessment may also incorporate identification and monitoring of large redemptions by investors.
    - Examples of quantitative metrics used in arriving at a liquidity assessment may include volume metrics, market depth, reasonably anticipated size of trade, as well as third party assessments of liquidity of the underlying portfolio assets.
        - for fixed income funds, examples of quantitative metrics used in arriving at a liquidity assessment may include volume metrics provided by third party trading platforms, broker-dealer quotes, volatility, bid-ask spreads, fund holdings relative to outstanding issue size, and other internal estimates such as market depth.
    - Examples of qualitative metrics used in a liquidity assessment may include the credit quality of underlying portfolio assets, investor concentration in the fund, investor profile, industry risk, geographic risk and the specific terms and conditions of underlying portfolio securities.

4. ***Set internal liquidity thresholds and targets that management of the fund can use to assess the liquidity profile of a fund and make any necessary adjustments.***

- Establish effective internal liquidity thresholds that are proportionate to the redemption obligations and liabilities of the fund.
- For example, in addition to ensuring compliance with the illiquid asset restrictions under NI 81- 102, a fund may elect to impose an internal limit (min/max) of underlying portfolio assets that could be convertible to cash in a certain number of days and classify those assets accordingly. These internal liquidity thresholds would be monitored on a regular basis.

5. ***Report material liquidity events in a timely manner for consideration by relevant personnel of the IFM.***

- Internal LRM reports contain sufficient information to understand the liquidity issues, actions taken and whether any further actions or approvals are necessary.
- Funds may implement early and timely identification of significant redemption requests in their reporting framework for further consideration and potential action.

6. ***Where possible, identify emerging liquidity concerns and potential liquidity shortages.***

- Although funds may not predict or foresee all liquidity events, monitoring market conditions and early identification of the resulting impact on a fund's portfolio, including potential liquidity shortages, will support effective management of a fund's liquidity risks.
- A firm's LRM policies and procedures may also outline procedures before and after a liquidity shortage occurs, and also identify when the use of LRM tools may be appropriate.

3. *Stress Testing*

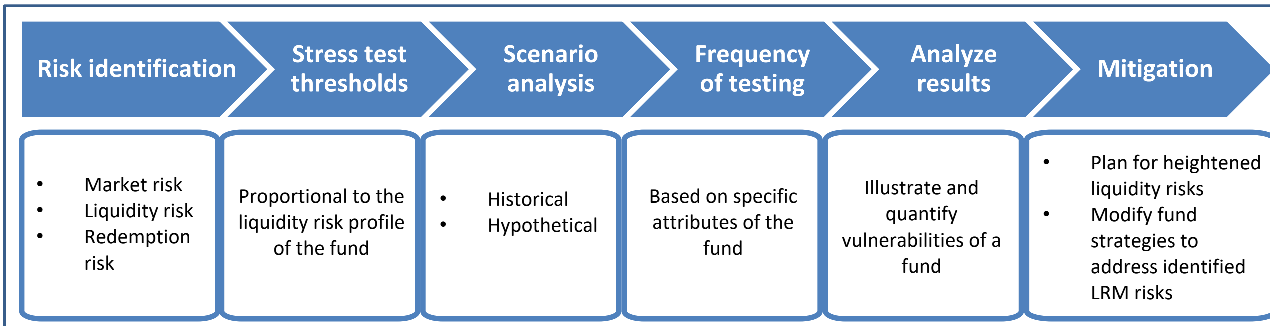

Figure 3.

While conducting stress testing is not specifically required under securities legislation, the guidance in this section identifies some of the key factors to consider when conducting stress testing.

Stress tests are important validation tools that enable a fund to assess the liquidity of its underlying portfolio assets, relative to the redemption flows under various market conditions and may be included as part of an effective LRM process to ensure that funds are prepared to respond appropriately to liquidity risks.

Stress testing simulates stressed events and market conditions and liquidity events in order to understand their implications on the fund's ability to meet redemption requests. While effective stress testing will likely be independent from the portfolio management function, it is acknowledged that this may not be possible in a smaller fund. An effective stress test will depend on the ability to create meaningful and relevant stress scenarios based on the use of reliable, relevant and current data. Funds that adopt stress testing may benefit from written stress testing policies that are reviewed and approved regularly.

There may be different ways to incorporate stress testing or scenario testing into the LRM framework. Stand-alone stress testing processes may be included as part of the overall LRM compliance function to measure the effect of significant one-off transactions. Certain historical stress or scenario data points may also be directly built into establishing operational liquidity thresholds and/or targets, such as largest redemptions (historic stress test) or largest client redemptions (scenario stress test).

The stress testing process is summarized in Figure 3 and described in more detail below.

Identification of Risks

The identification of key risks includes but is not limited to, market and redemption risk.

Market risk reflects the potential loss due to factors that affect the overall performance of the financial markets, such as movements in interest rates, recessions or geopolitical events.

Redemption risk reflects the potential for an unusual amount of redemptions to occur in a limited period of time.

While not an exhaustive list, a fund may also choose to incorporate one or more of the following events or risks in their stress testing, which may affect the fund or underlying portfolio assets held by the fund:

- general market stress or disruption[11]
- market stress affecting a class or subclass of assets
- interest rate risk
- credit risk
- reputational risk
- redemption risk
- geopolitical risk
- other sources of liquidity risk

Stress tests that anticipate reasonably foreseeable stressed market conditions and include relevant risk factors to which the fund could be exposed, may be most useful. Effective stress testing would also be proportionate to the liquidity risk profile of the fund.

Scenario Analysis

Stress tests can cover a range of scenarios that reflect a spectrum of events and severity levels. The complexity can range from a simple sensitivity test (using a single factor) to complex stress tests (using multiple factors), which aim to assess the impact of severe events. While stress test scenarios can take on a variety of forms, it is important that they are diverse and reflect material risks relevant to the fund. IFMs should incorporate reliable and up-to-date market information and may take into

[11] For example, with the recent COVID-19 pandemic, we experienced reduced market trading, significant market volatility and other market disruptions.

account the behavior of other market participants, whose actions may separately or collectively have an effect on the liquidity of the fund and/or its underlying portfolio assets.

When conducting a scenario analysis, IFMs may consider a number of factors including:

- downgrade of credit rating of an underlying portfolio asset or of the issuer of the underlying portfolio asset,
- changes in interest rates,
- widening of bid-ask spreads, and
- economic shocks.

For example, the following factors may result in a change in liquidity:

- a significant decrease in trading volumes and the widening of the bid-ask spreads can result in a decrease in the liquidity of the underlying portfolio assets,
- an unexpected downgrade of a fixed income security may lead to market uncertainty about the credit quality of an underlying portfolio asset which would then decrease the liquidity of the underlying portfolio asset,
- a sharp increase in interest rates for fixed income funds will result in a potential reduction in the valuation of the underlying fixed income portfolio, which in turn may lead investors to redeem units due to portfolio losses, and
- disruptive and volatile markets may impact the valuation and time that may be needed to dispose of underlying portfolio assets, which may decrease liquidity of the fund portfolio.

Staff acknowledge the ability to accurately forecast the number of days to liquidate asset positions and to reliably forecast investor redemption requests has limitations. Stress testing can help IFMs exercise their professional judgement to make decisions that are in the best interest of investors, but it is not a substitute for this responsibility.

There are typically two forms of stress testing used: historical and hypothetical scenarios.

Historical stress testing is backward looking and is based on the use of historical statistical events to assess risk, with the objective of quantifying the impact of an event (i.e., the dot-com crash in 2000 or the global financial crisis of 2008-2010) on the liquidity of a fund.

Further factors to consider for historical stress testing scenario analysis may include:

- comparison of historical cash flows with industry-wide cash flows for funds of similar size and strategy,
- redemption activity of the largest investor or group of investors,
- redemption activity during stress conditions (with varying percentages of redemption requests), and
- historical redemption patterns.

Hypothetical stress testing is forward looking and measures the potential impact of an event which has not yet occurred.

Further factors to consider for hypothetical stress testing scenario analysis may include:

- individual or a combination of factors, such as interest rate changes, increased redemption requests, and decrease in sales,

- changing investors, markets, or investment portfolio composition, and
- the potential for counterparty default (i.e., if collateral holdings are a significant percentage of a fund's assets and the counterparty either fails to meet payment obligations or terminates derivative contracts earlier than expected).

Frequency of stress testing

The frequency of stress testing will also need to be determined and may depend on the specific attributes of a fund, such as:

- size of the fund,
- nature of the underlying portfolio assets,
- redemption frequency,
- investment strategy,
- investor base, and
- market conditions.

Stress Testing Results

Stress testing results may be documented, analyzed, communicated and shared with relevant personnel to illustrate and quantify the vulnerabilities of a fund.

Stress testing results may:

- help ensure the fund is sufficiently liquid,
- strengthen the manager's ability to manage fund liquidity in the best interests of investors,
- include planning for periods of heightened liquidity risk,
- help identify potential liquidity weaknesses, and
- assist risk management monitoring and decision-making.

The committee overseeing liquidity risk matters should be informed of the stress testing results and any related actions taken, such as underlying portfolio asset changes.

4. Disclosure of Liquidity Risks

Prospectus Disclosure

Funds must provide full, true and plain disclosure of material risks associated with an investment in the fund in the prospectus.[12] This includes material liquidity risks.

The fund's prospectus requires disclosure of specific information concerning any material risks associated with an investment in a mutual fund.[13] Staff is of the view that liquidity risk may be a material risk of a fund. Investors may find disclosure around the actions to be taken by a fund in the event of a liquidity problem to be useful and informative. The fund's prospectus also requires disclosure that under extraordinary circumstances, the rights of investors to redeem securities may

[12] Or other documents for funds that are not in continuous distribution.
[13] Item 9, Part B of Form 81-101F1 *Contents of Simplified Prospectus* (**Form 81-101F1**); see also Item 12.1 of Form 41-101F2 *Information required in an Investment Fund Prospectus* (**Form 41-101F2**).

be suspended by the mutual fund, and a description of the circumstances when the suspension of redemption rights could occur.[14]

If a fund has a small number of large investors, consider the need for large redemption risk disclosure, which would include disclosing what the fund intends to do if faced with large redemptions.

Example – Large Redemptions Risk Disclosure
ABC Fund may have one or more investors who hold a significant number of units. For example, two financial institutions may have a significant principal investment. If a financial institution makes a large redemption request, ABC Fund may be required to sell underlying portfolio assets so that it can meet the redemption obligations. This sale may impact the market value of those portfolio investments and it may potentially impact remaining investors of ABC Fund. Large redemption requests for institutional investors could force ABC Fund to terminate. The fund may agree with the large institutional investor to make part of the redemptions in-kind, by transferring assets of an equal value to the large redeeming investor, if assets of the fund cannot be sold at advantageous prices without a significant impact to the value of the asset.

Annual Information Form

A fund's annual information form (**AIF**) requires detailed information concerning the governance of the mutual fund. This may include, among other items, information concerning: (i) the group responsible for fund governance, including disclosure of whether any members of this group are independent of the portfolio management function and (ii) policies and procedures of the fund or its manager relating to risk management controls, and if a fund manager does not have written policies and procedures around LRM, then this should be disclosed to investors.[15]

Example – AIF Disclosure
Fund X has an LRM committee that is responsible for the oversight of policies and procedures related to LRM. This committee is comprised of at least one member who is independent of portfolio management, in addition to representatives from the fund manager, the portfolio manager, compliance, and product development, each of whom has relevant subject matter expertise. LRM is part of the fund's broader risk management process which includes documented internal policies pertaining to the measurement, monitoring, mitigation and reporting of liquidity risks within the fund.

Continuous Disclosure

Disclosure of liquidity risks and events enhances an investor's understanding of the performance of the LRM process. A fund's management report of fund performance requires a discussion of how changes to the fund over the financial year affected the overall risk of investing in the investment fund.[16]

Funds should consider disclosing any significant liquidity challenges faced over the relevant period, how those challenges affected the fund and how they were addressed. A narrative discussion of the changes in the risk level of a fund over a financial reporting period due to changes in market conditions, significant redemptions, or liquidity of the underlying portfolio assets may be informative

[14] Item 6(2), Part A of Form 81-101F1.
[15] Item 12 of Form 81-101F2 *Contents of Annual Information Form*.
[16] Item 2.2, Part B of Form 81-106F1 *Contents of Annual and Interim Management Report of Fund Performance*.

for investors. Such disclosure may be meaningful to investors because it enables investors to understand the operation and effectiveness of the fund's LRM practices and the overall framework. All funds are reminded of their timely reporting obligations, which may include the disclosure of material liquidity events or risks affecting the fund.

5. LRM Tools

IFMs have various tools and techniques that can be employed to manage liquidity during stressed market conditions. While certain of these are specifically provided for under securities legislation (for example, suspension of redemptions under section 10.6 of NI 81-102), other liquidity tools that are not specifically provided for in securities legislation may require exemptive relief from NI 81-102 in order to use them.

Although not frequent, there are circumstances where a confluence of market forces may cause a fund to use LRM tools to aid in the ongoing liquidity management of the fund. In such scenarios, the activation of such tools should be subject to the consideration of certain overarching principles:[17]

Exceptional circumstances – the use of a mechanism that affects redemption rights is only justified in open-ended funds in exceptional circumstances. Generally, they should be used sparingly and be temporary in nature. Moreover, exceptional circumstances are rare, such as where a fair and robust valuation of the assets (e.g. lack of liquidity in the market place which could include certain forced asset sale scenarios), 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.

Best interest of investors – the use of such extraordinary tools must be in the best interest of the fund investors collectively. The fund should only use such tools when it is in the interest of investors and when the fair and equal treatment of incoming, ongoing and outgoing investors is maintained. Firms should always consider what is best for investors (new and old) when making the decision to implement such tools.

CSA Staff will consider whether to permit the use of liquidity tools that do not comply with NI 81-102 on a case by case basis. We encourage IFMs to contact their principal regulator on a timely and proactive basis and apply for exemptive relief as needed.

D. Conclusion

Effective LRM is an essential element of the management of an investment fund. If a fund does not manage its liquidity risk properly, there could be adverse outcomes for the fund and its investors. For this reason, taking a proactive and preventative approach to LRM is critical to ensuring that this risk is appropriately managed and dealt with in a timely manner, as it is very challenging to address material liquidity problems after they occur.

The CSA expects each IFM to establish and maintain an effective LRM framework that is consistent with its compliance with the IFM Statutory Conduct Standard and its obligations under NI 31-103, as well as ensuring that the investment funds it manages comply with their obligations under NI 81-102. The incorporation of an effective LRM framework into the IFM's broader risk management systems will help promote the interests of the fund's securityholders by reducing the risk of material liquidity

[17] IOSCO "*Open-ended Fund Liquidity and Risk Management – Good Practices and Issues for Consideration*" https://www.iosco.org/library/pubdocs/pdf/IOSCOPD591.pdf.

mismatches and thereby mitigate the risk of the fund being unable to satisfy redemption requests.

The CSA will continue to monitor LRM of funds as part of our ongoing continuous disclosure review program and consider future policy initiatives as needed. We also encourage IFMs experiencing liquidity concerns to proactively approach their principal regulator.

Questions

Please refer your questions to any of the following:

Neeti Varma Manager, Investment Funds and Structured Products Branch Ontario Securities Commission 416-593-8067 nvarma@osc.gov.on.ca	**Ritu Kalra** Senior Accountant, Investment Funds and Structured Products Branch Ontario Securities Commission 416-593-8063 rkalra@osc.gov.on.ca
Stephanie Tjon Senior Legal Counsel (Secondment), Investment Funds and Structured Products Branch Ontario Securities Commission 416-593-3655 stjon@osc.gov.on.ca	**George Hungerford** Senior Legal Counsel Corporate Finance Division British Columbia Securities Commission 604-899-6690 ghungerford@bcsc.bc.ca
Chad Conrad Senior Legal Counsel Corporate Finance Alberta Securities Commission 403-297-4295 chad.conrad@asc.ca	**Brandon Rasula** Legal Counsel Corporate Finance Alberta Securities Commission 403-355-6298 brandon.rasula@asc.ca
Gabriel Chénard Senior Policy Analyst Investment Funds Oversight Autorité Des Marchés Financiers 514-395-0337 ext. 4482 Toll-free: 1 800 525-0337, ext. 4482 Gabriel.Chenard@lautorite.qc.ca	**Olivier Girardeau** Senior Analyst Investment Funds Oversight Autorité Des Marchés Financiers 514-395-0037 ext. 4334 Toll-free: 1 800 525-0337, ext. 4334 Olivier.Girardeau@lautorite.qc.ca

Patrick Weeks Corporate Finance Analyst Manitoba Securities Commission 204- 945-3326 patrick.weeks@gov.mb.ca	**Heather Kuchuran** Director Corporate Finance Financial and Consumer Affairs Authority of Saskatchewan 306-787-1009 **heather.kuchuran@gov.sk.ca**