

Annex B

Proposed Changes to Companion Policy 81-102 *Investment Funds*

1. *Companion Policy 81-102 Investment Funds is changed by this Document.*

2. *Part 2 is changed by adding the following:*

“liquidity risk management framework”

2.8.1 A liquidity risk management framework should include all of the elements set out in the requirements in Part 6.1 and any other practices or mechanisms to manage liquidity risk, including, but not limited to, the disclosure of liquidity risk and liquidity risk management tools, as applicable.

3. *Part 3 is changed by replacing section 3.3.1 with the following:*

3.3.1 The Canadian securities regulatory authorities are of the view that illiquid assets are generally more difficult to value, for the purposes of calculating an investment fund's net asset value, than assets which are liquid. As a result, where a non-redeemable investment fund has a large proportion of its assets invested in illiquid assets, this raises concerns about the accuracy of the investment fund's net asset value and the amount of any fees calculated with reference to net asset value. Accordingly, staff of the Canadian securities regulatory authorities may raise comments or questions in the course of their reviews of the prospectuses or continuous disclosure documents of non-redeemable investment funds where such funds have a significant proportion of their assets invested in illiquid assets.

4. *The following Part is added:*

PART 8.1 LIQUIDITY RISK MANAGEMENT

8.1.1 Liquidity Risk Management Framework

- (1) Subsection 6.1.1(1) requires that an investment fund establish and maintain a liquidity risk management framework.

The liquidity risk management framework should take into account

- the liquidity profile of the investment fund's assets and liabilities,
- current market conditions,
- redemption activity,
- investor behavior, and
- the unique characteristics of the investment fund.

As part of the establishment and maintenance of the liquidity risk management framework, the investment fund should consider how to obtain and assess information from various sources across different functions of the manager and portfolio adviser(s), where applicable, and 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 manager.

- (2) Subsection 6.1.1(2) requires that the investment fund establish, maintain, and apply policies and procedures in respect of the management of liquidity risk. Such policies and procedures should be detailed and written.

- (3) Paragraph 6.1.1(2)(c) provides that the matters to be addressed in policies and procedures relating to liquidity risk management must include any other matter relating to liquidity risk management that is not specified in paragraphs 6.1.1(2)(a) and (b). Such matters may include circumstances in which it is not possible to obtain reliable and independent valuations for portfolio assets, to the extent that this is not already addressed in the manager's policies and procedures relating to valuation.

Such matters may also include conflicts of interest between the investment fund and the manager that may arise due to liquidity issues for investment funds that are not required to have independent review committees pursuant to NI 81-107. For example, there may be a conflict of interest if the level of a portfolio adviser's compensation is based on the level of the portfolio's returns, as a portfolio adviser may be incentivized to invest in more illiquid assets that have the potential for higher returns relative to more liquid assets, even though the more illiquid assets may not be suitable for the investment objectives or redemption needs of the investment fund. The Canadian securities regulatory authorities remind investment funds that are required to have independent review committees pursuant to NI 81-107 that any conflicts of interest that may arise due to liquidity issues must be addressed pursuant to the applicable requirements in NI 81-107. In addition, the Canadian securities regulatory authorities remind managers that sections 13.4 and 13.4.1 of National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* ("NI 31-103") apply to managers in respect of an investment fund that is not subject to NI 81-107.

8.1.2 Operational Requirements

- (1) Subsections 6.1.2(1) and (2) require a manager to, for a newly established investment fund, ensure that the investment fund's investment objectives and investment strategies and permitted redemption frequency of its securities align with the nature of its expected portfolio assets and expected redemption activity of its securities.

The permitted redemption frequency of the securities of an investment fund is the dealing frequency of the investment fund. For example, mutual funds generally have daily redemptions.

The nature of an investment fund's expected portfolio assets would include the types of assets held in the portfolio and the quantity of time required to dispose of and settle those assets.

The expected redemption activity of the securities of an investment fund may depend on the types of securityholders of the investment fund. For example, the expected redemption needs of an investment fund that primarily has retail investors will likely be different from the expected redemption needs of an investment fund that primarily has institutional investors. The expected redemption activity may also depend on the type of investment fund. For example, an investment fund that is targeted at investors with a longer time horizon will typically have different expected redemption activity compared to a money market fund.

- (2) Subsection 6.1.2(3) requires an investment fund to monitor, review and assess the investment fund's liquidity profile and relevant market conditions on an ongoing basis.

The Canadian securities regulatory authorities are of the view that this requirement will help ensure adequate levels of liquidity exist to meet redemption needs and enable the early identification of the impact of market conditions on the portfolio of the investment fund.

The liquidity profile of an investment fund is the ability of the portfolio of the investment fund to be disposed of and settled quickly and easily without a significant loss in value. As part of the requirement to monitor, review and assess its liquidity profile and relevant market conditions, the Canadian securities regulatory authorities are of the view that an investment fund should regularly review the composition of its portfolio assets, including cash and short-term securities, with consideration of past redemption activity, distribution channels, investor base, fund performance, and any other special considerations, such as changing market or other economic factors. In particular, an effective assessment should incorporate the identification and monitoring of large redemptions by investors.

- (3) Subsection 6.1.2(3) specifies the use of qualitative and quantitative metrics.

Examples of qualitative metrics may include

- the credit quality of underlying portfolio assets,
- investor concentration in the investment fund,
- investor profile,
- industry risk,
- geographic risk, and
- the specific terms and conditions of underlying portfolio securities.

Examples of quantitative metrics may include

- volume metrics,
- market depth,
- reasonably anticipated size of trade, and
- third party assessments of liquidity of the underlying portfolio assets.

Specifically, for fixed income funds, examples of quantitative metrics 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.

- (4) Subsection 6.1.2(4) requires that an investment fund establish and maintain liquidity thresholds and targets. For example, in addition to ensuring compliance with the illiquid asset restrictions under the Instrument, an investment fund may elect to impose internal minimum and maximum limits for portfolio assets that could be convertible to cash in a certain number of days and classify those assets accordingly. Certain historical stress data points may be directly built into establishing liquidity thresholds and/or targets of the investment fund, such as largest redemptions or largest client redemptions.
- (5) Subsection 6.1.2(5) requires that an investment fund conduct stress tests of the liquidity of the investment fund's portfolio assets. Stress testing is a risk management technique used to evaluate the potential effects of changes to certain factors that impact liquidity corresponding to exceptional but plausible events on the liquidity of an investment fund's portfolio. Stress testing simulates stressed events, market conditions and liquidity events in order to understand their implications on an investment fund's ability to meet redemption requests.

- (6) Subsection 6.1.2(5) requires that the stress tests include the application to the stress tests of historical and hypothetical scenarios that are relevant to the liquidity profile of the investment fund. The use of such scenarios is often referred to as scenario analysis.

Historical scenario analysis 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 on the liquidity of an investment fund. Factors to consider for historical scenario analysis may include

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

Hypothetical scenario analysis is forward-looking and measures the potential impact of an event which has not yet occurred. Factors to consider for hypothetical scenario analysis may include

- interest rate changes,
- increased redemption requests,
- decreases in fund sales,
- changes in investors, markets, and portfolio composition, and
- the potential for counterparty default.

The Canadian securities regulatory authorities are of the view that investment funds should consider including reverse stress testing as part of the stress tests. Reverse stress testing is a risk management technique where a predetermined outcome, usually a defined failure point, is used to identify the specific circumstances or scenarios that could lead to that outcome.

- (7) Subsection 6.1.2(5) requires that the stress tests involve historical and hypothetical scenarios that are relevant to the liquidity profile of the investment fund. Stress tests should cover a range of scenarios that reflect a spectrum of events and severity levels. It is the view of the Canadian securities regulatory authorities that they should be diverse and reflect material risks relevant to the investment fund, such as credit risk, reputational risk, and geopolitical risk. When designing scenarios for a stress test, a manager may consider a number of factors, such as

- a downgrade of the credit rating of an underlying portfolio asset or of the issuer of the underlying portfolio asset,
- a change in interest rates,
- a widening of bid-ask spreads,
- a change in the value of foreign currency, and
- an economic shock.

For example, it may be appropriate for an investment fund for which collateral comprises a significant proportion of its portfolio assets to conduct stress testing that also covers the collateral. This is because collateral posted by the investment fund's counterparties in derivatives and securities lending transactions may affect the liquidity of the investment fund if the counterparties are unable to meet their obligations under stressed market

conditions and the investment fund has to liquidate the collateral due to the counterparties' inability to meet their outstanding obligations to the investment fund.

Depending on the nature of the investment fund, the types of assets held by the investment fund, and market conditions, the complexity of the stress tests may range from a simple sensitivity test using a single factor to complex stress tests using multiple factors.

While the stress testing scenarios used should be consistent over a period of time so that the scenarios can be compared and analyzed over time, they should also be updated regularly to reflect changes in market conditions, the composition of the portfolio, and any other conditions that may impact liquidity. Investment funds should incorporate reliable and up-to-date market information in their stress tests.

- (8) As part of the stress tests required under subsection 6.1.2(5), an investment fund should consider using a "pro-rata" methodology rather than a "most liquid first" methodology in all of the scenarios used. A "pro rata" methodology would involve all investors receiving a proportional share of the portfolio assets when the assets are sold to meet redemption demands, whereas a "most liquid first" methodology would involve the manager prioritizing the liquidation of the most liquid assets first to meet redemption demands.
- (9) Subsection 6.1.2(6) requires that, if market conditions are normal, an investment fund conduct stress tests at least quarterly. However, an investment fund may determine that it is necessary to conduct stress tests on a more frequent basis. This determination may be based on specific attributes of the investment fund, including
 - the size of the investment fund,
 - the nature of its underlying portfolio assets,
 - its redemption frequency,
 - its investment strategy,
 - the types of investors invested in the investment fund, and
 - current market conditions.
- (10) Subsection 6.1.2(7) requires that, if market conditions are stressed, an investment fund increase the frequency of the stress tests until market conditions are normal. The Canadian securities regulatory authorities are of the view that during stressed market conditions, there may be unexpected or unanticipated market changes, investor behaviour, etc., which could suddenly decrease the liquidity of the portfolio of an investment fund, and therefore, there is a need for more frequent stress testing to ensure the ability of the investment fund to satisfy redemption requests. Examples of stressed market conditions may include market-wide or economy-wide events, such as global pandemics, and events that are relevant for certain types of funds, such as significant changes in interest rates that would likely impact fixed income funds.
- (11) Subsection 6.1.2(9) requires that an investment fund establish and maintain contingency plans that address liquidity risk, including, for greater certainty, contingency plans that include the use of liquidity risk management tools. Contingency plans are operational arrangements to address liquidity challenges during stressed market conditions. Liquidity risk management tools may include the suspension of redemptions, redemptions in kind, and the use of redemption fees.

8.1.3 Oversight

- (1) Subsection 6.1.3(1) requires that an investment fund appoint a liquidity risk management supervisor or establish a liquidity risk management committee. In the case of an investment fund that establishes a liquidity risk management committee, the committee may be an existing committee that covers multiple areas within its mandate, one of which would be liquidity risk management.

The Canadian securities regulatory authorities recognize that it may not be appropriate for some smaller managers to establish a liquidity risk management committee due to resource limitations, and that it may be more appropriate for them to appoint a liquidity risk management supervisor instead.

- (2) Subsection 6.1.3(2) sets out the individuals who can be appointed as a liquidity risk management supervisor. However, the liquidity risk management supervisor should engage with any individuals involved in decision-making relating to the purchase and sale of portfolio assets in order to obtain any necessary information or insights to better understand liquidity risks from the perspective of portfolio management. The engagement may take the form of involving such individuals as advisers to the liquidity risk management supervisor.
- (3) Subsection 6.1.3(3) requires the involvement of either the chief compliance officer of the manager or an individual who reports directly to the chief compliance officer of the manager as a member of the liquidity risk management committee. The liquidity risk management committee should also either include an individual involved in decision-making relating to the purchase and sale of portfolio assets or engage with any individuals involved in decision-making relating to the purchase and sale of portfolio assets for the same reason. The engagement may take the form of involving such individuals as advisers to the liquidity risk management committee or including them in meetings on an as-needed *ad hoc* basis.
- (4) Paragraphs 6.1.3(5)(a) to (h) set out specific functions of the liquidity risk management supervisor or liquidity risk management committee. The liquidity risk management supervisor or liquidity risk management committee should consult any individuals with relevant expertise or knowledge, as needed, in order to fulfill each such function. However, the Canadian securities regulatory authorities remind managers that the ultimate designated person and chief compliance officer of the manager are still responsible for the compliance of the manager with securities legislation under sections 5.1 and 5.2 of NI 31-103.
- (5) Paragraphs 6.1.3(5)(a) to (h) refer to approvals granted by the liquidity risk management supervisor or liquidity risk management committee, as applicable. The liquidity risk management supervisor or liquidity risk management committee should consult any individuals with relevant expertise or knowledge, as needed, in order for the liquidity risk management supervisor or liquidity risk management committee to grant approval. In addition, the liquidity risk management supervisor or liquidity risk management committee should maintain proper books and records relating to the decision-making process with regard to the approval.
- (6) Subsection 6.1.3(6) references a matter that would reasonably be expected to significantly impact the liquidity profile of the investment fund. An example of such a matter is a significant redemption request.

5. These changes become effective on ●.