

# Transcript



**Marcy Einarsson** 0:11

Welcome to "Policy to Practice," a new podcast series from SIMA, where we break down the policy and regulatory developments shaping Canada's investment industry and what they mean for firms working across the sector. I'm Marcy Einarsson, Director of Regulatory Compliance at SIMA. Today we're discussing liquidity risk management for investment funds, which we'll refer to as LRM. Back in November, the CSA released a request for comments on proposed amendments to National Instrument 81-102 relating to LRM.

The CSA also published a consultation paper for feedback covering other potential changes to the regulatory framework for LRM. Joining me is Bryana Lee, Senior Legal Counsel in the Investment Management group at the OSC. Bryana, thanks very much for joining us.



**Bryana Lee** 1:00

Thank you for having me, Marcy. It's an honour to be your first guest on this series.



**Marcy Einarsson** 1:04

Well, we're fortunate to have you, and our podcast series is off to a great start. So, before we get into the details, here are three things for listeners to know about this consultation.

First, The CSA is proposing amendments that would strengthen the liquidity risk-management framework for investment funds by addressing these key areas: a fund's LRM framework, operational LRM matters, and oversight of the LRM framework. At the same time, the CSA published a consultation paper that seeks feedback on potential further changes to the regulatory framework for LRM, including LRM tools, liquidity classification of underlying portfolio assets, and regulatory disclosure and data relating to LRM.

Second, the proposed amendments might affect how funds monitor and manage liquidity risk, which could have operational implications for firms.

And third, this initiative reflects regulatory efforts we're seeing globally to ensure that investment funds can meet redemption requests during periods of market stress in a way that is fair to all investors and to reduce the risk of liquidity crises. Bryana, let's start with the broader context.

So LRM is already a core part of how funds operate, but it's also an area that regulators internationally have been examining more closely. So, from a regulatory perspective, why has LRM become such a focus in recent years?

 **Bryana Lee** 2:34

So there are a few reasons for this. Firstly, a strong LRM framework enables investment funds to manage liquidity under various market conditions, which protects both redeeming and remaining investors in a fund. In addition, ensuring that all funds have strong LRM frameworks helps reduce the risk of liquidity crises that could impact the entire financial system and help maintain confidence in our capital markets. So you're right, Marcy, that there has been a lot of work in this area done internationally, particularly by the International Organization of Securities Commissions, known as IOSCO, and the Financial Stability Board, or FSB, in the past few years, particularly in the form of recommendations and guidance for securities regulators.

So, securities regulators around the world have been working to strengthen their regulatory frameworks in this area in response to, and in alignment with, this work. So that's another reason why LRM has been such a regulatory focus around the world.

 **Marcy Einarsson** 3:30

And when regulators think about liquidity risk in investment funds, what are the risks that they're trying to address?

 **Bryana Lee** 3:37

So, one risk is that an investment fund that doesn't have a strong LRM framework may not be able to manage its liquidity in a way that enables it to meet redemption requests in an orderly fashion without disadvantaging remaining investors, particularly during stressed market conditions. So, an example of this would be a

fund that isn't able to meet redemption requests from investors without selling portfolio assets urgently at significantly discounted prices, which would hurt all investors.

Another risk is what I mentioned earlier, which is the risk of contagion across the entire financial system. Reducing the risk of a liquidity crisis for individual funds by strengthening their LRM frameworks helps reduce the risk of such a crisis spreading across the entire financial system.



**Marcy Einarsson** 4:20

So, at a high level then, the concern is making sure funds can meet redemption requests in an orderly way, even during periods of market stress, and that funds do this without creating negative outcomes for the remaining investors, and then also preventing liquidity crises that could spread and affect the entire financial system.



**Bryana Lee** 4:40

Exactly. You got it.



**Marcy Einarsson** 4:43

Good. That context is super helpful. So, let's turn now to the consultation itself. In November of last year, the CSA released proposed amendments related to LRM as well as a consultation paper. What are the key elements that regulators are proposing to change?



**Bryana Lee** 5:00

So, the proposed rule amendments and consultation paper covered different but related topics. The proposed rule amendments specifically set out requirements relating to the LRM framework of a fund, operational LRM matters, and oversight of the LRM framework.

At a high level, those requirements include requiring that a fund establish and maintain an LRM framework, including having policies and procedures, requiring that LRM be considered and monitored throughout the lifecycle of a fund, and requiring an LRM supervisor or LRM committee to provide oversight of the LRM framework. The consultation paper, on the other hand, covers three additional areas of LRM for

which we're not quite yet ready to put out proposed rule amendments, because we want stakeholder feedback on some preliminary ideas that we have before we propose specific requirements. The areas covered in the paper are LRM tools, commonly referred to as LMTs, liquidity classification of underlying portfolio assets, and regulatory disclosure and data relating to LRM. So, for LMTs, the paper seeks feedback on whether there's a need to permit or even require the use of LMTs that are not currently permitted to be used in Canada. The thinking here is that additional LMTs may be needed to help investment funds better manage liquidity in a way that is fair to all investors. For liquidity classification, the paper sets out a potential liquidity classification framework which would help fund managers better manage risk, give investors greater transparency into the liquidity of the fund's portfolio, and improve the ability of regulators to monitor for system-wide liquidity trends and risks.

And finally, for regulatory disclosure and data, the paper sets out potential disclosure and confidential reporting requirements that are aimed at providing investors with, again, greater transparency and strengthening regulators' ability to monitor for system-wide risks.



**Marcy Einarsson** 6:53

Are these proposals primarily about formalizing practices that already exist in the industry, or are there areas where regulators are looking to introduce new expectations?



**Bryana Lee** 7:04

It's a great question, Marcy. So, with respect to the proposed rule amendments relating to a fund's LRM framework, operational LRM matters, and oversight of the framework, much of what we're proposing is a codification of the guidance on LRM that was published back in 2020 in CSA Staff Notice 81-333.

Our understanding from extensive stakeholder consultations that we conducted prior to publishing the proposed rules is that the vast majority of fund managers that manage publicly offered funds, as well as fund managers that manage large numbers of funds that are not publicly offered, already manage their funds in a way that is largely consistent with what was in the prior Staff Notice, as well as what's in the

proposed rules. So, in those cases, the proposed rules are mostly formalizing practices that are already taking place. Fund managers that manage small and medium numbers of funds that are not publicly offered may be starting from a lower state of alignment with what we've proposed, although there are also fund managers in this group that are also already managing their funds in a way that is largely consistent with what we're proposing. And the areas in which the proposed rules may set some new or modified expectations for some fund managers may be aspects of the oversight requirement, as well as the requirement for quarterly stress testing during normal market conditions.



**Marcy Einarsson** 8:21

OK. And how does this work then fit into the broader policy work the CSA has been doing in the investment fund space?



**Bryana Lee** 8:29

This work is a continuation of the CSA's broader efforts to modernize investment fund regulation, which has three overall policy objectives.

First, to modernize disclosure requirements to reflect how investors actually receive and use information.

Secondly, to reduce unnecessary regulatory burden where investor protection is not compromised.

And thirdly, to update rules to reflect evolving product structures and market practices. And this LRM work is also part of a broader shift towards data-driven supervision of investment funds, which is consistent with the CSA's mandate to identify, monitor, and mitigate systemic risk.



**Marcy Einarsson** 9:07

Well, the name of the podcast is "Policy to Practice," so let's switch focus and talk a bit about what this could mean in practice for firms. So, for people listening across the industry, whether they're in portfolio management, risk, compliance, or operations, where do you see the most significant implications of these proposals?

**BL** **Bryana Lee** 9:28

The proposed rule amendments would impact different areas within a fund manager's business — from those designing a new investment fund, to those responsible for doing the day-to-day LRM, which would include those in portfolio management, risk management, and operations, to those who'd be responsible for oversight, such as those in compliance. It's hard to say where the most significant implications would be within an organization, as it may depend on a fund manager's organizational structure, their current LRM framework, and how much their LRM framework may already be in compliance with the proposed rules.

 **Marcy Einarsson** 10:00

Are there then particular areas where firms may need to revisit existing frameworks or internal processes if these proposals move forward?

**BL** **Bryana Lee** 10:11

So, as I mentioned earlier, a lot of this will depend on whether the LRM framework is already largely in compliance with the proposed rules. But in any event, I think every fund manager would need to go through the rule amendments to figure out what changes they would need to make, if any, whether that's to update their policies and procedures regarding stress testing, for example, or to create, modify, or perhaps formalize their oversight of the LRM frameworks of their funds.

 **Marcy Einarsson** 10:36

That makes sense, and I'm sure many firms are either planning for or already performing this kind of assessment. So, speaking of changing processes, whenever regulatory frameworks evolve, firms are balancing strong risk management with operational practicality. So how does the CSA think about that balance in this case?

**BL** **Bryana Lee** 10:58

Great question again, Marcy. So as always, we try our best to balance the various regulatory concerns in everything we do, which includes understanding and reflecting industry concerns around operational practicalities. So, in the case of this LRM project, we were very intentional in seeking out industry feedback early on in the process and reflecting that feedback in the proposed rules. So specifically, we

conducted extensive stakeholder consultations on both the proposed rules and the consultation paper, including with SIMA, as well as differently sized fund managers, before publishing them for comment. The consultations were very helpful. We took the feedback that we received from them to improve the proposed amendments, including to reflect operational practicalities, all the while making sure that the proposed rules would still address the risks that we discussed earlier. For example, we heard consistent feedback from industry members that the proposed oversight requirements should be more principles based and more flexible to reflect the needs and resources of fund managers of different sizes, and we integrated that feedback into the proposed oversight requirements to allow for different types of oversight structures, while still making sure that the need for proper oversight is met.

Another example is that we received feedback about how often stress testing should be conducted, and we again reflected that feedback into the proposed stress testing requirements so that stress testing would be conducted frequently enough to be useful from an LRM perspective, but without being so frequent as to be burdensome without improving the management of liquidity risk.



**Marcy Einarsson** 12:27

So those are great insights into the CSA's process. The consultation period closed on March 27, and industry participants, including SIMA, have submitted comments. Bryana, what happens next after the consultation period ends, and what factors typically shape how proposals evolve at this stage?



**Bryana Lee** 12:48

The two parts of the project will be moving ahead in different ways. For the proposed rule amendments, we'll review and consider the comments that we received and figure out whether we need to make any changes. The rules will then need to be published in final form before they can come into effect, so we'll follow the standard rule-making process.

For the consultation paper, we'll need to review all the comments received and consider what is the appropriate next step. Depending on the feedback received, this could involve publishing proposed rule amendments that set out the specific changes we propose to make in the areas covered in the consultation paper. In any

event, nothing in the consultation paper will become a rule until it goes through the full rule-making process, which would involve publishing proposed rules for comment and then final rules. So stakeholders will have a chance to formally comment on any proposed rules that may come out of the consultation paper. And you'll have to stay tuned to see what comes next.



**Marcy Einarsson** 13:40

Oh, we always do! So, while that process is underway, what should firms be paying attention to right now? And are there areas where it would make sense for firms to start thinking about how their frameworks align with the direction of travel here?



**Bryana Lee** 13:56

I'm sure that fund managers are already aware of CSA Staff Notice 81-333, which was the notice that I mentioned earlier that sets out guidance on LRM. And until any LRM rules come into effect, the Staff Notice is still the go-to document to understand the CSA's expectations when it comes to LRM and it's the foundation for the proposed rules.

For firms that want to look ahead and think about how their LRM frameworks align with where things may be moving, certainly looking through the materials that the CSA published in November would be very helpful. But also, I think taking a look at the work coming out of IOSCO and the FSB in the past few years gives good insight into what securities regulators around the world are thinking about in this area as well.

**Marcy Einarsson** 14:38

What would you advise that firms listening today take as one practical takeaway from this consultation?

**Bryana Lee** 14:45

The proposed rule amendments and consultation paper together are intended to further strengthen the LRM frameworks of funds in a way that aligns with international work in this area so that funds can meet redemption requests in an

orderly fashion without disadvantaging remaining investors and to also reduce the risk of liquidity crises that could impact the entire financial system.

**BL** **Marcy Einarsson** 15:05

Bryana, thank you for joining us and sharing your perspective on this consultation. Today we talked about why liquidity risk management has become such an important focus for regulators, the changes the CSA is proposing, and what firms should be paying attention to as the process moves forward. Thank you for listening to "Policy to Practice."