

**MEMO# 30117**

August 4, 2016

# **Hong Kong Securities and Futures Commission - Liquidity Risk Management Guidance**

[30117]

August 4, 2016

TO: ICI GLOBAL REGULATED FUNDS COMMITTEE No. 47-16

INTERNATIONAL MEMBERS No. 16-16

SEC RULES MEMBERS No. 39-16 RE: HONG KONG SECURITIES AND FUTURES COMMISSION - LIQUIDITY RISK MANAGEMENT GUIDANCE

On July 4, 2016, the Hong Kong Securities and Futures Commission (“SFC”) issued a circular to provide guidance to management companies of SFC-authorized funds on liquidity risk management, Circular to management companies of SFC-authorized funds on liquidity risk management (“Guidelines”). [\[1\]](#) The SFC developed the Guidance based on good practices that it identified during its examination of funds’ liquidity risk management practices and international regulatory principles and good practices. Illustrated examples of good practices are included in the Guidance. Managers also are directed to take into account the 2015 SFC circular on fair valuation of fund assets and the following papers by the International Organization of Securities Commissions: (1) Principles on the Suspension of Redemptions (2012); (2) Principles on Liquidity Risk Management (2013); and (3) Principles on the Valuation of Collective Investment Schemes (2013). The SFC will monitor international regulatory developments related to liquidity risk management and may provide further guidance.

**Background.** Managers should at all times exercise due care, skill and diligence in managing the liquidity of funds under their management to ensure that funds are able to meet redemption requests, consistent with the terms set out in a fund’s documents, and that investors are treated fairly. Failure to properly manage liquidity can result in the inability to meet redemptions, adverse impacts for a fund and remaining investors, and could contribute to a first mover advantage, i.e. if redeeming investors do not bear the full cost of redemptions, investors may be incentivized to redeem their investments ahead of others, triggering a cycle of redemptions. Consequently, effective liquidity management is important to safeguard the interests and fair treatment of investors but also to maintain the robustness of funds and market integrity.

**Governance.** Liquidity risk management is a manager responsibility and should be integral

to the manager's risk management program. Liquidity risk management policies should be well-documented, reviewed periodically and supported by strong governance and operational capability. Governance structures can vary; however, each manager should have the following:

- a liquidity risk management function that is functionally independent from day-to-day portfolio investment function (although it may be part of the risk management function) that monitors liquidity risk on a day-to-day basis;
- appropriate oversight, including monitoring and management of liquidity risk, by a committee or senior management, where a majority of the members of the committee or senior management are independent from day-to-day portfolio management;
- an appropriate mechanism and process to enable a manager to assess, review and decide on actions needed upon short notice to meet liquidity demands under sudden and stressed conditions.

Fund design and disclosure. Managers should consider whether a fund's subscription and redemption arrangements are appropriate for the fund's investment strategies and assets. To that end, the manager should:

- understand the liquidity profile of the fund's assets under different market conditions;
- understand the liquidity profile of the fund's investors and align that profile with that of the fund's assets;
- seek to understand the profile of the fund's investors and their historical and expected redemption patterns;
- determine the appropriate dealing frequency, notice period and fund size, taking into account the liquidity profiles of the fund's assets and investor profiles as well as arrangements and tools in place to manage liquidity;
- identify the appropriate liquidity risk management tools that the fund can use and include the ability to use such tools in the fund's documents;
- disclose in the fund's documents the significance and potential impact of liquidity risk on the fund and its investors, a summary of the liquidity risk management process and the tools that may be employed to address those risks.

Ongoing assessment. The Guidance directs that managers should assess the liquidity profile of fund investors and the fund on a regular basis and other potential sources of liquidity risk, e.g., margin calls. This includes considering historical liquidity demands and expected future demands, including for similar funds under likely future conditions where appropriate. The manager regularly should assess the liquidity of the fund's portfolio under current and likely future market conditions and classify fund assets into different categories.

- Examples of quantitative metrics or qualitative factors include
  - days to trade, costs to trade, time to maturity
  - qualitative factors such as asset class or credit quality
  - composite categories such as high, medium and low liquidity
- Managers should exercise professional judgement in determining reasonable and appropriate metrics and factors for liquidity assessment and categorization, taking account of asset and market characteristics.

Managers should set internal liquidity targets or indicators, in the form of minimum and maximum amounts to be invested in assets in each liquidity category (and review such targets or indicators to take account of changes). Indicators or targets should be based on investment strategy, assets, investor profiles, market conditions, fund disclosure and other

relevant factors. Where more than one fund with similar strategies and assets is managed by a manager, it may be appropriate to assess the liquidity of these funds in the aggregate.

Managers are expected to assess the fund's liquidity position against the targets or indicators, choosing a hard target approach, i.e. manager must adjust the portfolio to the target within a reasonable time when not meeting the target, or a soft approach, i.e., the indication would cause the manager to perform analysis and consider whether further action should be taken, including changing the product design and disclosure. The manager should have in place well-documented policies to escalate incidents to responsible persons or a committee where a fund is unable to meet targets or indicators. Managers also should maintain appropriate documentation of ongoing liquidity risk assessments and actions.

**Stress testing.** The Guidance recommends liquidity stress testing on an ongoing basis to assess the impact of "plausible severe adverse changes in market conditions on the liquidity of the funds and the adequacy of the [manager's] action plans and liquidity risk management tools" (paragraph 19). Stress test scenarios based on backward looking historical market conditions and redemption demands of the fund (and similar funds) should be developed by the manager. The testing should include assessments of the impact of specific factors and a combination of factors. Managers also should consider forward looking hypothetical scenarios where appropriate and practicable. Stress testing should be done regularly and as needed due to changing conditions. Stress testing similar funds managed by a manager in the aggregate also may be appropriate. Stress testing should be reviewed by the committee responsible for liquidity risk management or senior management to determine if further action is warranted. Stress test results also should be integrated into investment decision-making and risk management processes. Further, managers should be prepared to articulate rationales behind stress test scenarios, maintain documentation of testing and actions taken in light of results.

**Liquidity risk management tools.** Protecting the interests of investors should be the primary consideration for managers and take priority over considerations like reputation or competitive concerns. Available tools should be subject to ongoing review. Managers should consult with custodians before tools are used and maintain clear internal procedures when tools will be used and the responsibilities of various parties in deciding to use the tools and implementing the tools. Offering documents should describe the tools, when the tools may be used, the impact of the tools on the fund and investors and any risks to investors. Liquidity risk management tools can be categorized as follows:

- tools to delay or limit redemption and/or to allow the orderly processing of redemptions, e.g., agreements to provide advance notice for large redemptions, discretion to suspend, deferring processing of redemptions on a pro-rata basis;
- tools to fairly allocate the costs of redemption and eliminate first mover advantage, e.g., "special emphasis" on valuation procedures and policies, swing pricing, anti-dilution levy, in-kind redemption, closure and liquidation; and
- other sources of liquidity, e.g., lines of credit, borrowing.

**Compliance.** SFC-authorized managers are expected to implement the Guidance as soon as practicable but no later than January 1, 2017. Generally managers based in other jurisdictions with acceptable inspection regimes or mutual recognition are expected to follow their home country requirements consistent with international standards. Offering documents of SFC-authorized funds should have current information and be updated as needed as a result of the Guidance.

Susan Olson  
Chief Counsel - ICI Global

**endnotes**

[1] The Guidelines are available at  
<http://www.sfc.hk/edistributionWeb/gateway/EN/circular/doc?refNo=16EC29>.

---

Copyright © by the Investment Company Institute. All rights reserved. Information may be abridged and therefore incomplete. Communications from the Institute do not constitute, and should not be considered a substitute for, legal advice.