Ontario Securities Commission

OSC Staff Notice 81-727 Report on Staff's Continuous Disclosure Review of Mutual Fund Practices Relating to Portfolio Liquidity

June 25, 2015

OSC ONTARIO SECURITIES COMMISSION

Purpose of this Notice

Staff of the Investment Funds and Structured Products Branch (**Staff** or **we**) of the Ontario Securities Commission (**OSC**) recently conducted targeted reviews focused on mutual fund practices relating to i) liquidity assessments of fund holdings, ii) liquidity stress testing, and iii) liquidity valuation considerations. This notice provides a summary of our findings and related guidance.

Objectives and Scope of Our Review

Units of mutual funds, including exchange-traded mutual funds (**ETFs**) (together, **funds**), are redeemable on demand, and funds generally offer their securities on a continuous basis. To facilitate purchases and redemptions of funds' units on a daily basis, funds are required to invest primarily in liquid investments in accordance with National Instrument 81-102- Investment Funds (**NI 81-102**). When holding primarily liquid investments, funds are able to provide reliable and objective valuations of the fund's net asset value (**NAV**); which in turn enables the fund to meet investor redemption requests without significant disruption to the portfolio.

In late 2014, we commenced a series of targeted reviews of funds investing in asset classes that may be more susceptible to liquidity concerns. Staff focused on the following three fund categories:

1. High yield debt funds, including funds that focus on senior loans investments;

2. Emerging market funds; and

3. Small capitalization equity funds.

Our review focused on the following three areas:

1. Liquidity assessments of fund holdings: Staff assessed whether funds have appropriate policies and procedures to identify potential illiquid assets.

2. Liquidity stress testing: Staff assessed whether funds have appropriate policies and procedures to manage higher levels of redemption requests in an orderly manner under various stress scenarios.

3. Liquidity valuation considerations: Staff assessed whether funds' valuation processes have appropriately taken liquidity into consideration.

In total, we reviewed 22 funds, consisting of conventional mutual funds and ETFs managed by 16 investment fund managers (**IFMs**). The 16 IFMs manage approximately $391 billion in assets under management (**AUM**).
We did not find any practices or disclosures that resulted in a referral to either OSC's Compliance and Registrant Regulation or Enforcement branches.

Background

While the mutual fund industry consists largely of funds focused on traditional asset classes, such as equities and investment grade debt, staff have noted an increase in fund offerings with asset classes that may have higher liquidity risks. The mutual fund industry has approximately $1.3 trillion in AUM, while ETF AUM is approximately $81 billion. As of February 2015, approximately 7% of total industry AUM was held in high yield global fixed income funds, 4% in Canadian, U.S. or global small/mid cap funds and 1% in emerging market equity funds.

Review Observations and Recommendations

Liquidity Assessments of Fund Holdings

Observations

Liquidity metrics

We found IFMs monitor varying metrics across asset classes in assessing the liquidity of their funds' holdings. As fixed income and debt holdings are not generally traded on exchanges, IFMs utilize a number of market quality metrics to determine the level of liquidity for these assets. These metrics include the number of dealers making a market, frequency of quotes, bid-ask spreads, outstanding issue size and frequency of price movements.

For listed equity investments, most IFMs use liquidity metrics, such as trading volume and bid-ask spreads. We found that some IFMs have the view that equity investments are liquid as long as the investments are listed on an exchange, without further consideration of market activity and conditions.

Many IFMs have established assessment or review committees to determine whether a security is illiquid. In addition to representations from the fund manager, these committees often consist of technical experts, such as portfolio advisors and fund accountants. Once a security is flagged as an illiquid asset, the review committee determines what actions need to be taken to ensure compliance with securities laws and the fund's investment policies.

Staff recognizes there is considerable judgment involved in liquidity assessments. Review committees can add objectivity and expertise into the assessment process for IFMs.

Monitoring of Liquidity

During our review we found instances, in particular funds focused on small capitalization issuers, where investment holdings have not exhibited trading volume or market activity needed to support the disposal of investments in a short period of time. These funds took corrective action and decreased their illiquid holdings to an appropriate level to ensure compliance with NI 81-102. To ensure compliance with securities laws, the IFMs for these funds developed policies and procedures to monitor a holdings' liquidity on a frequent and timely basis.

Illiquid investments, by their nature, can be difficult to dispose of. As a result, corrective actions can potentially cause significant disruption to a fund's portfolio. Staff supports ongoing liquidity monitoring as an important preventive tool.

Recommendations

1. Written policies and procedures

Funds should have robust written policies and procedures on liquidity assessments at the time of an investment purchase and on an ongoing basis. The liquidity assessments should be based on objective and relevant quantitative metrics on an ongoing basis as market activity and conditions can vary and decline over time.

We expect funds to tailor their policies and procedures, as well as liquidity metrics, for different asset classes. While not an exhaustive list, they should consider the following metrics noted from the review that were used in making liquidity assessments:

- Volume metrics (e.g. average daily or weekly trading volume)
- Bid-ask spreads
- Number of participants making a market for the holding
- Outstanding issue size

2. Market activity and conditions

The definition of "illiquid asset" in NI 81-102 refers to the ability to readily dispose of a portfolio asset through a market facility on which public quotations are available at a price that approximates the amount at which the portfolio asset is valued. Being listed on a stock exchange with a quoted price alone, in staff's view, is not generally sufficient to conclude that a particular holding is liquid. A stock listing does not necessarily mean that an equity investment could be readily disposed at a price that approximates the last market transaction or is within the current bid-ask spread.

Based on the redemption requirements set out in NI 81-102, specifically the requirement that redemption requests must be settled in 3 business days, IFMs should consider whether the funds' investment holdings can be readily disposed of in this period without a significant adverse impact to the portfolio. In considering market activity, IFMs can compare the size of a particular investment holding with the trading volume of such investment.

Liquidity Stress Testing

Observations

Current Practices

We found most IFMs engaged in some type of stress testing on an ongoing basis to assess the ability of a fund to meet unexpected large redemptions. However, some did not. We noted others conducted scenario analysis to assess the ability of the portfolio to meet redemptions, but this analysis incorporated only historical redemption rates without consideration of higher levels.

IFMs of funds investing in emerging market securities were generally more rigorous in stress testing their portfolios on an ongoing basis. Emerging market portfolios were typically subject to bi-weekly or ad-hoc discussions and analysis regarding their geographical and country specific exposure, geopolitical events and currency exposures.

Further, we found that funds investing in asset classes that have higher liquidity risks generally had investment parameters designed to mitigate such risks. For example, funds that invest in senior loans typically held higher cash levels and had higher degrees of diversification in the fund's holdings.

We see stress testing as a prudent way for IFMs to ensure funds can manage unexpected large redemption requests together with stressed market conditions.

Recommendations

1. Standalone stress testing

Funds should have written stress testing policies and procedures in place to ensure the fund can effectively execute redemptions in stressed market conditions. Written procedures can speak to the order in which assets may be liquidated to minimize the negative impact to the portfolio and the remaining unitholders.

2. Scenario analysis

When performing stress testing, IFMs should build into the scenario analysis redemption rates that exceed their past redemption experience. Together with liquidity stress testing, IFMs should consider stress testing for portfolio performance. As liquidity of underlying investments, large redemption requests and stressed market conditions tend to correlate with each other, effective stress testing should take into consideration different market conditions that would affect the performance of the funds. For example, for fixed income funds, consider the impact on the portfolio should interest rates change. Emerging market funds could consider the impact of a particular geopolitical uncertainty.

3. Risk discussion and investment parameters

Funds with higher exposure to potentially illiquid assets should provide additional disclosure and ongoing discussion of the risk management policies and investment restrictions in place designed to mitigate liquidity risk. Funds can provide risk management discussion in the investment strategies section of the prospectus or management discussion and analysis in the management report of fund performance (**MRFP**). We think better risk management discussion provides clarity of the fund's investment policies and can enhance investor understanding and expectations. Staff found that some funds investing in senior loans, for example, have disclosed more defined investment restrictions around cash and marketable investment holding levels, and use of liquidity metrics, such as minimum tranche size and credit quality, as part of their strategies to mitigate liquidity risk.

To enhance investors' understanding and expectation of the investment risk, funds should disclose material risks that would significantly impact their funds' performance. For example, a potential increase in interest rates may negatively impact performance for fixed income funds.

Liquidity Valuation Considerations

Observations

Valuation Practices

With respect to valuation, we found that closing market values were generally used for equity investments, including small capitalization issuers, without any further consideration of market activity and conditions.

For fixed income investments, we found IFMs accessed information helpful in assessing market activity and conditions. This included third party vendors providing over the counter broker quotes, and service providers who produce supplemental pricing information such as data freshness reports, quote sizes, and number of broker quotes. We found IFMs typically consider approximate price adjustments as a result of this supplemental information in the fair valuing of their fixed income holdings.

Recommendations

1. Fair value determination for NAV calculation purposes

Fair value is defined in National Instrument 81-106 Investment Fund Continuous Disclosure (NI 81-106) to mean (a) the market value based on reported prices and quotations in an active market, or (b) if the market value is not available, or the manager of the investment fund believes that it is unreliable, a value that is fair and reasonable in all the relevant circumstances.

We refer funds to International Financial Reporting Standards 13 (IFRS 13) Fair Value Measurements which sets out guidance for determining fair value, as well as the accompanying disclosure requirements.
IFRS has established a three level fair value hierarchy, based on the type of inputs used to measure fair value. For investment valuation purposes;

- Level 1 inputs are quoted prices (unadjusted) in an active market for identical investments.
- Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the investment either directly or indirectly.
- Level 3 inputs are unobservable inputs for the investment.

In order to measure an investment solely based on a quoted price, the fund must conclude that there is an 'active market' for the investment. IFRS 13 defines a market as active if transactions for the asset or liability occur with sufficient frequency and volume to provide pricing information on an ongoing basis. IFRS 13 also provides some guidance on when the volume or level of activity on a market may indicate that a transaction price or quoted price does not represent fair value.

Staff takes the view that a fund's determination of whether an investment is quoted in an active market under IFRS 13 must be a consideration in determining whether the investment meets the illiquid asset restrictions under NI 81-102.

2. Disclosure

If an investment is not quoted in an active market, then fair value is determined based on a consideration of other inputs, and additional disclosure with respect to those investments is required in the funds' financial statements in accordance with IFRS 13. We refer funds to IFRS 13 which sets out relevant disclosure requirements.

We encourage funds to provide additional information when fair valuing fixed income and debt instruments, as level 2 inputs are often used.

To the extent that the valuation procedures are different between NAV calculation and for financial statement purposes, item 5 of subsection 3.6(1) of NI 81-106 requires notes disclosure detailing and explaining the differences.

*3. Independent Review Committee (**IRC)** input on valuation of illiquid assets*

Given the actual and/or perceived conflict of interest that arises when IFMs value illiquid assets (such as when the IFM overrides valuations provided by external pricing sources), we expect IFMs to obtain standing instructions from the funds' IRC in regard to their valuation policies and procedures to ensure that any conflicts of interest are appropriately identified and mitigated.

Conclusion

We found that IFMs are generally aware of liquidity risks, and have taken liquidity risks into consideration in their day-to-day management of the funds. We did not find any practices or disclosures that resulted in a referral to either OSC's Compliance and Registrant Regulation or Enforcement branches.

We expect IFMs to use the guidance provided in this notice. Asset classes that may be more susceptible to liquidity concerns will remain a focus for Staff. We continue to monitor the development in this area, and will publish more guidance or take other regulatory action as needed.

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osc.gov.on.ca

If you have questions or comments about this report, please contact:

Ritu Kalra
Senior Accountant
Investment Funds &
Structured Products Branch
rkalra@osc.gov.on.ca
(416) 593-8063

Abid Zaman
Accountant
Investment Funds &
Structured Products Branch
azaman@osc.gov.on.ca
(416) 204-4955

Sovener Yu
Accountant
Investment Funds &
Structured Products Branch
syu@osc.gov.on.ca
(416) 593-2395

Raymond Chan
Manager
Investment Funds &
Structured Products Branch
rchan@osc.gov.on.ca
(416) 593-8128