Investment Management Alert

September 30, 2016

Key Points

- All managers of SFC authorised funds (including overseas managers of SFC authorised funds) are required to enhance internal liquidity risk management processes and procedures in order to implement minimum SFC requirements.
- The focus is on internal governance, product design, ongoing monitoring and stress testing.
- Compliance is expected as soon as practicable, with a hard deadline of 1 January 2017.

SFC Circular to Managers of SFC Authorised Funds Addressing Liquidity Risk Management

On 4 July 2016, the Hong Kong Securities and Futures Commission (SFC) issued a circular[1] (Circular) providing guidance to management companies (Managers) of SFC authorised investment funds (Authorised Funds) addressing liquidity risk management (LRM) issues for Authorised Funds.

Background

In a speech delivered on 14 June 2016[2], Ms. Julia Leung (then Executive Director, Investment Products of the SFC) described “liquidity risk” as “the risks that arise as a result of the mismatch between the liquidity profile of the assets and the liabilities of open ended funds.” Liquidity risk can generally be described as the mismatch between the liquidity of (i) the interests issued by a fund to investors and (ii) a fund’s assets.

The Circular was issued against the backdrop of an increased focus by regulators, driven by the International Organization of Securities Commissions (IOSCO), regarding how managers of open-ended investment funds (i.e., funds in which investors may elect to redeem out of the fund at their own volition) manage liquidity risks. Separately, regulators in other major financial centers have introduced regulations and guidance for managers of investment funds, including:

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1 “Circular to management companies of SFC-authorised funds on liquidity risk management” (4 July 2016) - http://www.sfc.hk/edistributionWeb/gateway/EN/circular/doc?refNo=16EC29

2 Keynote Speech, Liquidity Risk Management of Investment Funds (14 June 2016) http://www.sfc.hk/web/EN/files/ER/PDF/Speeches/JL_20160614.pdf

- United Kingdom - guidance issued by the Financial Conduct Authority (FCA): "Liquidity management for investment firms: Good Practice"(February 2016)[3] applicable to investment managers of open-ended investment funds
- Singapore - guidance issued by the Monetary Authority of Singapore (MAS): "Risk Management Practices – Liquidity Risk" (March 2013)[4] applicable to all financial institutions supervised by MAS.

The SFC also made reference to IOSCOs conclusions published in the "Principles on the Suspension of Redemptions" (2012), the "Principles on Liquidity Risk Management for Collective Investment Schemes" (2013)[5], and the "Principles on the Valuation of Collective Investment Schemes" (2013)[6].

Following a review of the international landscape for LRM and a focused review of the LRM practices of a number of managers of Authorised Funds, the SFC has identified and set out certain minimum requirements for managing the liquidity risks of Authorised Funds and has now documented these requirements in the Circular.

Concerns of the Regulator

The SFC has indicated that a key focus of the Circular is to assist Managers of Authorised Funds (including overseas-based managers of Authorised Funds) to ensure that their funds are more resilient and better placed to deal with liquidity shocks. Potentially adverse consequences arising from a failure to properly manage liquidity risk include:

- Inability of a Fund to Meet Redemption Requests – Illiquidity of fund assets may mean that a fund is unable to generate sufficient cash proceeds to settle investor redemption requests. This is of particular concern amongst funds offering daily liquidity.
- Adverse Impact on a Fund and the Remaining (Non-Redeeming Investors) – Actions taken by a manager in meeting redemption requests may change the risk profile of a fund. For example, if liquid assets are realized to satisfy redemption request(s), a fund may be left holding more illiquid assets. This is considered to be unfair to remaining investors.
- Redemption Cycle That Exacerbates Stress at Fund Level – If redemption costs are not borne by redeeming investors, this arguably creates a "first mover advantage" for redeeming investors and could result in a cycle of redemptions from a fund, thus exacerbating liquidity stress within a fund.

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[3] UK FCA Publication – "Liquidity management for investment firms: Good Practice" - https://www.fca.org.uk/publications/documents/liquidity-management-investment-firms-good-practice

[4] MAS Guidelines - http://www.mas.gov.sg/~/media/MAS/Regulations%20and%20Financial%20Stability/Regulatory%20and%20Supervisory%20Framework/Risk%20Management/Liquidity%20Risk.pdf

[5] See https://www.iosco.org/library/pubdocs/pdf/IOSCOPD405.pdf

[6] See http://www.iosco.org/library/pubdocs/pdf/IOSCOPD413.pdf

Looking beyond the micro level, the SFC also identified that a failure to properly manage liquidity risk within investment funds could also adversely impact the wider market, leading to fire sales of underlying assets and increasing market volatility during periods of challenging market conditions.

Key Areas for Consideration

The Circular highlights the following five key areas for consideration:

1. internal governance at Manager level
2. product design
3. ongoing liquidity risk assessment and monitoring
4. stress testing
5. LRM tools.

Each of these areas is examined in further depth below.

1. Governance

The Circular requires that Managers exercise due skill and attention in managing the LRM aspects of funds under their management in order to ensure that such funds are able to meet redemption requests from time to time in accordance with the offering documents and to ensure that all investors in a fund are treated fairly.

Further, the Circular provides that:

- the Manager shall be responsible for LRM compliance
- LRM is expected to be an integral part of a Manager's overall risk management programme
- a Manager is expected to establish effective and well-documented LRM policies and procedures for the funds that it manages
- a Manager's LRM policies and procedures are expected to be reviewed periodically.

The Circular provides that LRM policies and procedures should be supported by strong and effective governance and operational capability. Although the SFC acknowledges that governance structures will differ between Managers, the Circular indicates a minimum level of LRM that Managers are expected to implement:

(i) an LRM function (functionally independent from the day-to-day portfolio investment function) to monitor the implementation of LRM policies and procedures on a day-to-day basis. The LRM function may be part of the existing risk management function

(ii) an appropriate degree of oversight by a committee responsible for LRM or senior management over the LRM function and the ongoing management and monitoring of liquidity risk. A majority of the members of the committee or the senior management who perform the oversight role should be independent from the day-to-day portfolio investment function. Where the oversight is performed by a committee, the committee should comprise heads or senior staff of the relevant functions of the Manager

(iii) appropriate mechanisms and processes (including effective contingency planning) in order to enable the Manager to assess, review and decide on the actions required at short notice to meet the liquidity demands on the funds under sudden and stressed conditions. Examples would be setting risk-based parameters that trigger escalation to a senior level within the manager (for example, notice to liquidity risk manager/consideration by LRM committee/disposal of the asset) in the event of heightened levels of liquidity risk.

These provisions would generally be captured by appropriate updates to the Manager's compliance or operations manual.

2. Product Design and Disclosure

The second key area highlighted by the SFC relates to considering LRM as part of the process of structuring an investment fund in order to seek to minimize the risk of liquidity risk issues arising. Although Managers will likely already be familiar with a number of these considerations as part of their existing product design process, the SFC's minimum requirements provide a useful insight as to the standards that the SFC will be looking to see implanted. For each investment product, a Manager should:

(i) understand the liquidity profile of the fund's assets, both generally and under different market conditions (Managers should consider how assets that may ordinarily be considered as liquid may, in certain circumstances, become illiquid). This is of particular importance where a certain type of asset represents a significant percentage of the fund's assets. The SFC has also indicated that liquidity concerns have become greater as open-ended funds seek exposure to more exotic and less liquid assets. One example is the A-Share market correction in 2015, during which period a significant number of equities (traditionally considered as highly liquid) were suspended and could not be disposed of

(ii) understand the liquidity profile of the fund's liabilities (i.e., primarily being the fund's ability to satisfy investor redemption requests) and appropriately align these liabilities with the liquidity of the fund's assets

(iii) understand the profile of a fund's investors and their historical and expected redemption patterns. In better understanding how investors have (and might be expected to) behave, a Manager can seek to better align the liquidity profile of the fund's liabilities with its assets. The SFC appreciates that, in practice, a Manager may have only limited investor profile information, and, accordingly, the Manager is expected to take only "reasonable steps" to obtain this information when performing the liquidity assessment. The SFC highlighted that liquidity risk becomes more acute where a fund's investor base is concentrated in a few large institutional investors and also that large and unexpected redemptions can be problematic

(iv) ensure that the terms of the investment product are appropriate in light of the liquidity of the fund's assets, liabilities, investor base and liquidity management tools. This would include determining an appropriate (i) dealing frequency, (ii) notice period for redemptions and (iii) fund size (where appropriate)

(v) identify the appropriate LRM tools that the Manager may use to manage liquidity risk. Where appropriate, such tools (suspension powers, frequency of redemptions, lock-up periods, etc.) may be hardwired into the fund's constitutive documents

(vi) ensure that a fund's offering documents include appropriate disclosures as to the significance and potential impact of liquidity risks on a fund (and its investors). In practice, this would be addressed by a separate risk disclosure in the offering documents providing an overview of the fund's/the manager's LRM process and the tools that may be employed to address these risks. For new Authorised Fund applications, we are seeing the SFC insist on the inclusion of such disclosures in offering documents.

3. Ongoing Liquidity Risk Assessment and Monitoring

The third limb of the guidance seeks to ensure that the LRM procedures, policies and structuring design implemented at the inception of the investment product are continually monitored during the life of the investment product.

This requires regular monitoring of the key aspects of a fund's liquidity risk profile, including the liquidity profile of its assets and its liabilities, a fund's investor base, and the historical and anticipated redemption patterns.

The Circular places particular focus on fund assets, recommending that a Manager:

(i) classify a fund's assets into different liquidity classes

(ii) set internal liquidity targets/indicators in the form of minimum/maximum amounts that should apply to each liquidity category

(iii) assess a fund's liquidity position against the internal liquidity targets/indicators, and then take action in accordance with the agreed internal governance protocol for LRM.

Notwithstanding the requirement to analyze LRM at the asset level, the Circular reminds Managers that they should consider the results in a holistic manner and avoid making a liquidity assessment based on a single metric or factor.

4. Stress Testing

The fourth limb of the guidance can be viewed as an extension of the ongoing requirement on a Manager to assess the liquidity risk of a fund.

The Circular requires that Managers perform liquidity stress testing on their funds in order to assess:

(i) the impact of plausible severe adverse changes in market conditions on the liquidity of a funds

(ii) the adequacy of the Managers' action plans and LRM tools in addressing these changes.

The Circular does not impose minimum frequency requirements for stress testing other than to provide that Managers should perform stress testing regularly. In practice, this will be subjective, depending on the nature of the Manager, the risk profile of the fund and the composition of the fund's assets. More frequent stress testing would be expected for funds with more rapidly changing portfolio profiles, market conditions or investors. In addition, the Circular recommends the performance of further stress testing in circumstances where there are major changes to the key fundamentals impacting the liquidity risk profile: (i) the markets in which the fund invests, (ii) the structure or strategy of the fund or the Manager, and (iii) the investor base of the fund.

The Circular requires that, following stress testing, the results generated should be reviewed by the internal LRM committee responsible or senior management responsible for LRM in order to determine whether further action is warranted. Furthermore, stress test results should be adequately integrated into a fund's investment decision making and risk management processes.

5. Liquidity Risk Management Tools

The SFC provided guidance as to the types of tools that a Manager may use to manage the liquidity risk of an investment fund. These include (but are not limited to):

(i) tools and practices to delay the payment of redemption proceeds to investors and/or allow a Manager to make such payments in an orderly manner (i.e., gating, notice periods, ability to suspend redemptions and withhold payment of redemption proceeds, lock-up periods, etc.)
(ii) tools to allocate the costs of redemption redeeming investors and to mitigate the perceived "first mover advantage"
(iii) other sources of liquidity for the fund, such as access to a borrowing facility/credit lines.

The Manager should periodically review the LRM tools available to it, including in light of the stress testing and general changes in market conditions.

The Circular stresses that the primary purpose of LRM tools is to protect the interests of investors, rather than to protect the reputational risk of the Manager.

As part of the process of managing risk with investors, the Circular requires that a fund's offering documents include appropriate disclosures setting out (i) descriptions of the LRM tools, (ii) explanation of when the tools may be used, (iii) the tools' impact on the fund and investors, and (iv) any attendant risks to investors.

Implementation

The Circular provides that all Managers licensed or registered with the SFC are required to enhance their existing internal LRM processes and procedures in order to implement the minimum requirements set out in the Circular. Compliance is expected as soon as practicable, with a hard deadline of 1 January 2017.

For existing Authorised Funds, Managers are expected to update offering materials in order to ensure that investors are able to make informed investment decisions on investment. In our experience, this requires that offering documents include disclosures addressing the manager's policies and procedures for LRM, and the LRM tools used by the fund.

For new Authorised Fund applications, the SFC has indicated that it may seek further information from the applicant Manager in order to provide necessary comfort that the Manager has, or will put in place, measures to manage the liquidity risks of the fund.

Contact Information

If you have any questions regarding this alert, please contact the Akin Gump Strauss Hauer & Feld lawyer with whom you usually work or:

Anne-Marie Godfrey
anne-marie.godfrey@akingump.com
+852 3694.3040
Hong Kong

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