

---

**TO** : a. **Regulated Entities:**

- i. **Cyprus UCITS Management Companies and Self-Managed Cyprus UCITS ('CUCITS MCs')**
- ii. **Cyprus Alternative Investment Fund Managers and Self-Managed Cyprus AIFs ('CAIFMs')**

b. **Sub-Threshold Cyprus Alternative Investment Fund Managers and Self-Managed Cyprus AIFs ('sub- threshold CAIFMs')<sup>1</sup>**

**FROM** : **Cyprus Securities and Exchange Commission**

**DATE** : **February 10, 2023**

**CIRCULAR NO.** : **C548**

**SUBJECT** : **Guidance on Liquidity Risk Management ('LRM')**

---

Following the thematic reviews carried out by the Cyprus Securities and Exchange Commission ('CySEC') in the context of the 2020 Common Supervisory Action ('CSA') on UCITS liquidity risk management launched by the European Securities and Markets Authority ('ESMA'), and the findings presented in ESMA's public statement ['ESMA presents the results of the 2020 Common Supervisory Action \(CSA\) on UCITS liquidity risk management'](#)<sup>2</sup>, CySEC wishes to provide Regulated Entities with guidance aimed at assisting them to ensure compliance with their LRM legal obligations.

In addition, the following guidance is aimed at mitigating supervisory risks and concerns identified in the area of Liquidity Management and to further the protection of investors, maintaining market integrity and reducing systemic risk.

## **A. APPLICABILITY OF THE PRESENT CIRCULAR**

Although the 2020 CSA on LRM focused on CUCITS MCs and UCITS under their management, almost all of the areas reviewed relate to respective legal obligations of AIFMs. Therefore, the present guidance is also applicable to AIFMs and AIFs under their management, except where explicitly stated otherwise. References to "Regulated Entities" ('REs') or

---

<sup>1</sup> Sub-threshold AIFMs includes AIFMs and Internally Managed AIFs of the Republic, whose assets under management fall below the thresholds of section 4(2)(a) or 4(2)(b) of Law 56(I)/2013, as amended and have not chosen to opt in as per the provisions of section 4(6) of Law 56(I)/2013. Such AIFMs 'Level 1' legal obligations are set under Law 81(I)/2020 on Small AIFMs, in the event of externally managed AIFs, AILNPs and RAIFs or Law 124(I)/2018 on Alternative Investment Funds, as amended, in the event of internally managed sub-threshold AIFs and internally managed AIFLNPs.

<sup>2</sup> For information, purposes refer also to the [4<sup>th</sup> Annual Statistical Report on EU Alternative Investment Funds by ESMA \(February 2022\)](#) which highlights liquidity concerns for AIFs.

“Management Companies” (“**MCS**”) in the present circular correspond to the ‘Regulated Entities’ to which the circular is addressed to (i.e. CUCITS MCs and CAIFMs). It is noted that, whereas in cases of practical examples included in the present circular relevant to LRM, these may be more relevant to funds investing in transferable securities (due to the fact that the focus of the thematic review was on UCITS). In principle, a respective and analogous practice should be followed by RE’s investing in less liquid assets such as Real Estate and Private Equity, at product design, pre-investment and during on-going monitoring as well as when there is use of liquidity management tools/special arrangements, to ensure robust LRM and a well aligned asset-liability maturity structure.

In addition, bearing in mind the fact that the sub-threshold CAIFMs ‘Level 1’ legal obligations with regards to risk and liquidity risk management (i.e. Law 81(I)/2020 and/or Law124(I)/2018) are similar to the ‘Level 1’ relevant legal obligations of the CAIFMs (i.e. Law 56(I)/2013), CySEC also invites sub-threshold CAIFMs to consider the present circular as guidance to best practices they could adopt in order to comply with their relevant legal obligations.

## **B. LEGAL FRAMEWORK**

The regulatory framework based on which the present circular has been developed, is set out in the **Annex**.

## **C. GUIDANCE TO MANAGEMENT COMPANIES**

### **I. DUE DILLIGENCE IN THE SELECTION OF INVESTMENTS**

Regulated entities are expected to apply high standard of diligence in the selection of investments taking into account the investment strategy, liquidity profile and the redemption profile of the fund. In the case of UCITS funds where the redemption of units is obligatory upon request of the unitholder, REs are expected, where it is appropriate and after taking into account the nature of a foreseen investment, to formulate forecasts and perform analyses concerning the investment’s contribution to the UCITS portfolio composition and liquidity before carrying out the investment.

#### ***Guidelines***

1. REs must ensure, at pre-investment stage, that the liquidity profile, including the trading volume, sensitivity of prices and spreads of individual assets, in normal and exceptional liquidity conditions of the intended investments, is appropriate to the fund’s redemption policies and other liabilities inputs. This should take into account the investor concentration base /significant holdings, type of investors and investor redemption history, characteristics of the distribution channel and margin calls.
2. REs are expected to appropriately measure the effects of intended investments on the overall liquidity profile of the fund through the use of liquidity measurement arrangements and procedures. Tools/models/systems to be used to this end should capture the specificities of the fund’s portfolio assets and enable the assessment of the quantitative and qualitative risks of intended investments, especially those with

material impact on the liquidity profile of the portfolio of the fund's assets. Approaches used should be justified, forward looking and back tested to ensure reliability.

3. Good practice would see REs set appropriate internal definitions and thresholds that would trigger alerts relevant to the level of impact of a foreseen investment to the fund's liquidity risk and indicate the need to conduct more in-depth qualitative and/or quantitative liquidity analysis as part of the pre-investment due diligence process. REs could set rules with regard to the proportion of the portfolio indicating that could be liquidated within a specified period of time. Such limits could be directly integrated into the trading systems used by REs to preclude transactions that do not comply with these criteria. Consideration should be given to the global position held by all managed funds by the same fund manager in an asset when assessing the latter's ability to liquidate that asset.
4. In the event of a UCITS fund, REs are expected to formulate forecasts and perform analyses concerning the investment's contribution to the UCITS portfolio composition, where it is appropriate and after taking into account the nature of a foreseen investment (e.g. where the presumption of liquidity elaborated in Section C.II does not apply). To this end, appropriate factors and scenarios (under normal and stressed conditions) should be considered bearing in mind the asset type (e.g. bond, derivatives, equities) and trading place specificities of the asset. Forecasts should be formulated not only at security level, but also at asset class level so that certain risks that may affect an asset class and may be exemplified during an economic recession will be also captured. Forecasts are expected to be back-tested in order to review their validity and contribute to their improvement.
5. REs could develop and regularly update a list of asset classes that require more detailed liquidity analyses and/or forecasts given their specific liquidity characteristics and identify eligible assets that they will not invest in because of their high liquidity risks.

#### *Risk Management Policies/Procedures ('RM P&P') and Record Keeping*

6. REs are expected to ensure that their written RM policies elaborate on all procedures to be followed at the investment selection stage, on due diligence undertaken and the factors and characteristics considered and techniques, tools and arrangements used/applied. Further, RM P&P should be clear on the allocation of responsibilities pertaining to this stage of LRM and be representative of the exact activities and practices undertaken by the MC. REs are also expected to maintain adequate and orderly records/documentation relevant to related businesses and their internal organization in a way that enables the verification of the MC compliance with the relevant legal obligations. Among others, it is expected that adequate documentation is always available to demonstrate, with sufficient granularity, all investment selection activities and actions, including to provide the reasoning behind certain investment decisions. With regards to UCITS funds the decision making process of whether to execute or not pre-investment forecasts and analyses of liquidity should also be clearly documented.

## **II. USE OF PRESUMPTION OF LIQUIDITY AT PRE-INVESTMENT STAGE (APPLICABLE ONLY FOR UCITS FUNDS)**

Regulated entities shall use/rely on the presumption of liquidity only in the case of financial instruments admitted, or dealt in, on a regulated market in accordance with section 40(1)(a) to (d) of Law 78(I)/2012 and provided that the REs have ensured there is no information available to the UCITS that would lead to a different determination.

### ***Guidelines***

- 7.** REs should ensure that the presumption of liquidity is used only when investing in listed financial instruments and where there is no information available that would indicate the need for performing pre-investment liquidity forecasts and analyses. Over-reliance on such presumptions should be avoided and relevant caution exercised before undertaking these investments by executing checks to ensure there is no information available which would lead to a determination that the liquidity of such securities could be compromised.
- 8.** The obligation to ensure ‘there is no information available...’ indicates that before investing in financial instruments which are admitted or dealt in on a regulated market, REs are expected to consider the factors that potentially could affect their liquidity. This may be ongoing risk monitoring that could mitigate the risks involved, for instance, by applying a threshold to the issue size to estimate the trading volume. Regulated Entities should be in a position to justify the reliability of the methodology followed.
- 9.** REs are also expected to exercise due diligence, as set out in section C.I above, when not investing in financial instruments which are admitted or dealt in on a regulated market, regardless of the fact that the investments may not represent a material exposure to the UCITS. For example, where investments fall under the 10% ratio of article 40(2)(a) of Law 78(I)/2012 (the so called ‘UCITS trash ratio’) and/or where there is a high threshold of investments in liquid listed financial instruments in the portfolio and the UCITS is deemed sufficiently liquid to meet redemption requests, due-diligence still applies.
- 10.** During the on-going liquidity monitoring stage elaborated under Section C.III , REs are expected to perform follow-ups and retain ongoing controls on investments presumed liquid, using justifiable methodologies and based on reliable data on volumes e.g. past volumes, number of brokers and trading size. The lack of any data on volumes are likely to be viewed as a risk to sufficient liquidity and will need to be further investigated.

### ***RM P&P and Record Keeping***

- 11.** REs are expected to ensure that their written RM policies elaborate on all procedures that are followed relevant to the presumption of liquidity in UCITS, as well as due diligence undertaken and the factors and characteristics considered.. RM P&P should clearly allocate responsibilities pertaining to this subject and demonstrate the exact activities and practices undertaken by the MC. REs are also expected maintain adequate and orderly records/documentation of their relevant businesses and internal organisation in a way which enables the verification the MC’s compliance with their

legal obligations. Among others, it is expected that adequate documentation is always available to demonstrate, with sufficient granularity, the decision-making process on the application/exemption of the presumption of liquidity.

### **III. ONGOING MONITORING OF LIQUIDITY RISK - RISK MEASUREMENT, ONGOING ALIGNMENT OF REDEMPTION POLICIES AND LIQUIDITY PROFILES AND ONGOING ASSESSMENT OF THE LIQUIDITY OF THE OVERALL PORTFOLIO OF THE FUNDS UNDER MANAGEMENT**

Regulated entities are expected to ensure that the investment strategy, liquidity profile and the redemption policy of each fund under management are consistent, meaning that investors must have the ability to redeem their investment in a manner consistent with their fair treatment and in accordance with the fund's redemption policy and obligations.

#### ***Guidelines***

- 12.** REs are expected to have in place liquidity risk measurement and management arrangements which take into consideration both the asset side and liability side of liquidity risk. They should establish, implement and maintain a system of internal definitions and limits/thresholds concerning the measures used to manage and control the liquidity risks for each fund under management. The thresholds should act as a signal to carry out more extensive in-depth, quantitative and/or qualitative liquidity analysis as part of the liquidity risk management process. Such arrangements should be appropriate to the specificities of the fund, justified, forward-looking and back-tested to ensure their validity.
- 13.** With regards to the asset side of liquidity risk, REs are expected to implement and maintain appropriate liquidity risk measurement tools and arrangements to assess the risks of positions taken, especially those which have a material impact on the liquidity profile of the portfolio of the fund's assets. To this end, REs are expected to establish and maintain relevant liquidity risk measurement and monitoring tools/models, which should include a series of factors and indicators together with triggers and weightings. Sole reliance on 'ready-to-use' liquidity tools available in the market should be avoided.
- 14.** REs are also expected to implement and maintain tools and arrangements, which ensure the on-going monitoring of the liability side of liquidity risk, such as the redemption policies/ terms, investor redemption patterns and behaviours, margin calls arising from EPM and/or derivatives transactions and any other liabilities and/or commitments. In this respect, REs could:
  - 14.1** Keep a relevant investor and investor base qualitative and quantitative characteristics database. The database could include data on investor concentration /significant holdings, type and investment profile of investors, investor redemption history, characteristics of the distribution channel. The ongoing monitoring and analysis of such data should feed the assessment tools/models of the RE and enable it to carry out documented assessments of such data and their impact/possible impact on investor

redemption behaviour under normal and stressed periods and during extreme scenarios of heavy investor redemptions.

- 14.2 Where applicable, take into consideration the margin calls. In this respect, tools could be used to estimate the possible value of negative margin calls and payment obligations that might arise especially in a tense market environment. Such tools should assist the REs to determine the hedging requirements that might be needed should all positions be closed out amid a stressed market environment, as well as to evaluate whether the portfolio could mobilise enough cash to meet this payment.
- 14.3 Perform an analysis that involves consolidation of all liabilities. Thus, redemptions, margin calls and other liabilities analysis should be factored into the same models/tests so as to assess the global resilience of the funds, in this respect.
15. REs should execute combined assessments of asset and liability side liquidity risks in order to have an aggregate view on the liquidity profile of each of their funds under management and constantly monitor it. Methods adopted by MCs could include an estimation of liquidity profiles based on the percentage breakdown of the assets of each fund that can be sold within certain time periods/buckets and a comparison with the estimated redemptions and other liabilities over the same buckets. Other methods might include the use of 'Excess Liquidity' (measured as total buffer of liquid assets - stressed liabilities), the use of Redemption Coverage Ratio as an early warning signal for further in-depth analysis and remedial actions and the performance of qualitative assessments that consider funds' portfolio breakdown into high, medium and low liquidity buckets. Where applicable, such methods should take into account initial lock-up periods, notice periods and any other measures used to monitor redemptions.
16. REs are also expected to conduct liquidity stress tests to demonstrate that a fund will be likely to comply with applicable rules including regarding the ability of the fund to meet redemption requests in normal and stressed conditions. An important guide, the [ESMA Guidelines on Liquidity Stress Testing in UCITS and AIFs](#), was issued in July 2020 (ESMA34-39-897) and adopted by CySEC. Liquidity Stress Testing ('LST') should be carried out at least annually, however the Guidelines recommend this is carried out quarterly or more frequently.
17. REs are expected to identify and disclose in its policies and procedures and its offering documents, the types of circumstances where Liquidity Management Tools ('LMT'), including special arrangements, may be used in normal and exceptional circumstances, to manage the liquidity risk of each of the funds under management<sup>3</sup>. RE's should consider the use of such LMT with the aim of ensuring the fair treatment of investors in the fund.

---

3 Many papers published by international institutions such as IOSCO, ESRB, FSB and ESMA relevant to Liquidity Management Tools provide useful insights and guidance. These include the 2015 IOSCO Report on Liquidity Management Tools in Collective Investment Schemes (FR28/2015), the 2022 FSB Assessment paper of the Effectiveness of the FSB's 2017 Recommendations on Liquidity Mismatch in Open-Ended Funds and the 'ESMA Public Statement on the impact of war in Ukraine on investment funds' issued in May 2022 (especially section 'General principles in case of material liquidity issues and valuation uncertainties').

18. LRM mechanisms and methodologies should not be static in order to ensure the accuracy of LRM modelling based on the prevailing market circumstances (including during market downturns) and to avoid unrealistically stable or even improving liquidity estimations in a time of crisis.. Models should be adapted to reflect the market situation and the guidelines stress the importance of LRM that involves both risk managers and portfolio managers and the effective cooperation between the two functions to ensure there is a good comprehension of market developments. Moreover, the limitations of the models should be clearly understood to enable quick reaction/adaptation if required (e.g. change the % of daily volume, increase the cash position limit etc.).

#### *RM P&P and Record Keeping*

19. REs are expected to ensure that their written RM policies elaborate on all procedures followed at the ongoing liquidity risk monitoring stage, the due diligence undertaken, the factors and characteristics considered and the techniques, tools and arrangements used/applied. RM P&P should clearly allocate responsibilities at this stage of LRM and be representative of the exact activities and practices undertaken by the MC. REs are also expected maintain adequate and orderly records/documentation of relevant businesses and internal organization in a way which enables the verification of the compliance of the MC with their legal obligations.

#### **IV. DATA AVAILABILITY, RELIABILITY, SOURCES, SCREENING AND PROCESSING**

Regulated entities are expected to put in place risk measurement arrangements, processes and techniques necessary to ensure that the risks of positions taken and their contribution to the overall risk profile, including liquidity risk profile, are accurately measured on the basis of sound and reliable data. All decisions taken by the risk management function of the REs, including liquidity risk management decisions, are expected to be based on reliable data, which are subject to an appropriate degree of control by the risk management function.

#### ***Guidelines***

20. REs are expected to adopt and implement strong data quality control processes, including cross-checking different data providers and/or market data, back testing of the data and carry out coherence checks when gaps are observed in historical data to ensure their soundness, validity and reliability.
21. REs could use sources such as providers with expertise in the local market of the issuer, KIIDs/KIDs in case of investments in other UCITS/AIF funds, data from the regulated markets in which they invest, as well as conducting their own research. In the case of bonds where reliable data, especially relative to volume, is difficult to obtain, REs should try to establish a best estimate by drawing on multiple sources for bond data, e.g. using information from their trading desk or brokers to adjust their volume data or to integrate volumes that are not available on the main exchange. It is noted that the absence of data on volumes, even partial, should be considered as an adverse signal for liquidity.

22. Single reliance on one provider/ information source will not be considered adequate for meeting the relevant legal obligation, even where the provider/source is widely used in the industry.
23. With regard to data on liabilities, REs could aggregate different sources including depositaries, distributors, sales teams or Euroclear services, where applicable. In cases where inherent complications to the nature of liabilities prohibit the proper accounting and screening of liability data, REs could set and monitor a maximum threshold of unknown liabilities.
24. Where an RE has performed their own research, reliance should not be placed solely on an individual's experience and expert judgement without further documentation being produced, since such research is considered subjective. In contrast, research needs to be detailed and follow written pre-determined data reliability procedures.

#### *RM P&P and Record Keeping*

25. REs are expected to ensure that their written RM policies elaborate on all procedures related to data soundness and reliability verification and the due diligence undertaken. Further, RM P&P should clearly allocate responsibilities pertaining to this subject and be representative of the exact activities and practices undertaken by the MC. REs are also expected to maintain adequate and orderly records/documentation of relevant businesses and internal organization in a way which enables the verification of the compliance of the MC with the relevant legal obligations.

## **V. GOVERNANCE AND CONTROL MECHANISMS<sup>4</sup>**

### **i. Senior Management ('SM') and Board of Directors ('BoD') Responsibility - Reporting to SM and BoD**

Senior Management and Boards of Directors are required by specific obligations in the Law to ensure the MC's compliance with its legal obligations. This includes the oversight, approval, revision and verification of the effectiveness of the policies, arrangements and procedures in place. Specific reports are expected to be prepared and submitted to the SM and the BoD at an appropriate frequency to ensure they can comply with their obligations.

#### ***Guidelines***

26. The SM and the BoD of the MC are expected to assess and periodically review the effectiveness of the policies, arrangements and procedures put in place to comply with the obligations required by the relevant legal framework, including liquidity risk management policies, arrangements and procedures. To this end, Compliance, Risk Management and Internal Audit reports should be prepared and submitted to the SM and the BoD on a regular basis and at least annually.

---

<sup>4</sup> Refer also to [CySEC Circular 409 on Common deficiencies and best practice standards identified through on-site inspections regarding certain aspects of the AIFM governance](#). It is noted that, whereas the Circular is addressed to Alternative Investment Fund Managers, the majority of guidance included therein is applicable to UCITS Managers and should therefore be regarded by them as well.



- 27.** Due to the crucial importance of liquidity risk management policies and arrangements and procedures for the proper management of funds,, Compliance and Internal Audit Reports are expected to include checks relevant to LRM practices, policies and procedures at least on an annual basis, indicating in particular whether appropriate remedial measures have been taken in the event of any deficiencies that are identified.
- 28.** The Risk Management reports should be comprehensive and include details on the actual assessment of liquidity, a summary of investments / disinvestments and redemptions / liquidity indicators corresponding to the relevant period. Reports should include references on the parameters used and the application of the liquidity risk assessment process in terms of both quantitative and qualitative components, as well as references to the pre-investment analyses and the application and monitoring of the presumption of liquidity (applicable only to UCITS) and whether appropriate remedial measures have been taken in the event of any deficiencies. Any other information that would assist SM and the BoD to discharge their relevant legal obligation should be included.
- 29.** In addition to periodic reports (as set out in paragraph 27 above), reports and updates are expected to be submitted to the SM and/or the BoD of the Management Company by the Risk Management Function, as follows:
- 29.1** Depending on the nature and complexity of its business, the SM should receive reports on a regular basis which include adequate and appropriate elaboration on the implementation strategies and the internal procedures applicable to verify the proper and effective implementation / compliance with the general investment policy, investment strategies and risk limits- including liquidity risk limits- of each managed fund. Such reports are required to be regularly received by the SM, therefore the Risk Management Function should prepare and submit them to SM at least on a quarterly basis or more often depending on the nature scale and complexity of each fund under management.
- 29.2** The SM is expected to receive regular reports/updates by the Risk Management function on the current level of risk- including liquidity risk- incurred by each fund under management and any actual or foreseeable breaches of the set risk limits, including liquidity risk limits, to ensure that prompt and appropriate action can be taken. Such reports/ updates are required to be regularly received by the SM, therefore the Risk Management Function should prepare and submit them to SM at least on a quarterly basis or more often depending on the nature scale and complexity of each fund under management. Updates should be either written or their content should be evidenced in written form.
- 29.3** The SM is expected to receive, approve and periodically review at least annually, the Risk Management Policy, including liquidity risk management policy, together with the arrangements, processes and techniques for its implementation. This should also include review and approval of the risk limit system, including the liquidity risk limit system, for each fund under management.

29.4 The BoD is expected to receive regular reports/ updates by the Risk Management Function on the consistency between and compliance with the risk limits, including liquidity risk, for each managed fund and the risk profile agreed for those funds. The reports/updates should reflect on the adequacy and effectiveness of the risk management process, indicating in particular where appropriate remedial measures have been taken to address any deficiencies. Such reports/ updates are required to be regularly received by the BoD, therefore the Risk Management Function should prepare and submit them at least on a quarterly basis or more often depending on the nature scale and complexity of each fund under management. Updates should be either written or their content should be evidenced in written form.

30. All the above reporting should be frequent enough to enable the SM and/or BoD to discharge their relevant evaluation and oversight duties in a timely and proper manner. The frequency of reporting shall be determined based on the characteristics of the funds under management, such as the degree of exposure to potentially non-liquid and/or mostly less liquid assets and the concentration in a single or number of shareholders..

#### *RM P&P and Record Keeping*

31. REs are expected to ensure that their written RM P&P state the terms, content and frequency of reporting by the risk management function, the compliance function and, where applicable, the internal audit function, to the BoD and SM. Where such reports and/or specific content of such reports are explicitly required by the relevant legal framework to be reviewed, verified, and /or approved by the SM and/or the BoD, REs are expected maintain adequate and orderly records/documentation of these actions in a way that enables the verification of the compliance of the MC with the relevant legal obligations.

#### **ii. Liquidity Risk Management Decision Making and Escalation Processes**

It is of paramount importance, that clear decision-making processes govern all stages of LRM. MCs, taking into consideration the nature, scale and complexity of their business and the nature and range of services and activities undertaken in the course of that business, shall establish, implement and maintain decision-making procedures and an organisational structure that sets out reporting lines and clearly allocates functions and responsibilities. MCs must also ensure effective procedures are in place for internal reporting and the communication of information at all relevant levels of the company, and with relevant third parties regarding the exercise of activities. This flow of information is expected to drive the adoption of remedial measures in the event of any identified deficiencies, as well follow the progress and efficacy of actions taken.

## Guidelines

- 32. Risk Management Function role:** The risk management function is expected to participate with either decision-making powers or oversight/supervisory powers at all stages of decision-making relevant to LRM. To this end, it should be ensured that the provisions of the legal framework relevant to the hierarchical and functional independence of the risk management function apply at all times. In terms of hierarchical independence, the MCs are expected to ensure that the risk management function is granted with the necessary authority and access to all relevant information necessary in order to fulfil its risk management and risk oversight. In this way, the Risk Management function must at least be at hierarchically the same level on the MC organisational chart as Portfolio Management and Fund Administration.. In terms of functional independence, the management of risks of each fund under management must be either executed or supervised/overseen by the risk manager.
- 33.** With regards to functional independence of the risk management function, during the investment selection stage, it is the risk manager who is expected to perform or at the least supervise and approve the pre-investment analysis undertaken, including the appropriateness of the use of presumption of liquidity where it relates to a UCITS fund. In addition, during the ongoing LRM stage the risk management function is expected to have full responsibility for the efficient and effective functioning of the liquidity monitoring systems and mechanisms. Throughout such process, the risk management function is expected to collaborate with, co-ordinate and supervise all departments/persons relevant to the process and, where required by the legal framework, be entrusted with all relevant decision-making powers in order to ensure that the liquidity risk level complies on an ongoing basis with the fund's risk profile.
- 34. Product design stage decision-making:** It is suggested that REs have a New Products Committee or similar consisting of appropriate persons such as a risk manager, a portfolio manager and senior managers. Where the RE does not have a New Products Committee, the title/position of persons who will be involved in the product design phase must be included in the relevant policies and procedures. The people involved in the product design should be responsible for deciding the set-up of the liquidity characteristics of each new fund upon predetermined factors outlined in the MCs relevant policies and procedures. It is anticipated that the risk management function would be a prime participant in the product design phase.
- 35. Escalation processes:** REs should ensure that all issues requiring escalation to a higher organisational level such as the SM and/or the BoD a formal and detailed escalation procedure is put in place to ensure the timely, efficient and effective handling of realised or anticipated issues. Such processes should also be applicable where the matter involves delegated authority. REs are expected to ensure that delegation does not prevent or hinder the effective supervision of the fund where fund management activity has been delegated and that any realised or anticipated issue is escalated to the SM and BoD of the MC for remediation.

**36.** REs are expected to ensure that their written RM P&P:

36.1 Elaborates on the people involved in decision-making processes and their role for each of the aspects of LRM indicated above.

36.2 With regards to escalation, the RM P&P should provide for a formal and detailed escalation procedure to address both anticipated and actual liquidity issues. Such procedures should include the people responsible for initiating an escalation, how and when escalation should be triggered (e.g. when deficiencies are identified with regards to liquidity risk management), as well as the limits, criteria and severity thresholds on the specific type of escalation to be triggered. It should also outline the relevant steps to be followed with clear reporting channels, including a description of the possible decisions to be taken and persons responsible, and provide a clear process for remedial actions and follow-up.

36.3 With regards to the product design phase, the RM P&P should provide for a sound practice regarding the Product Design Phase should include, inter alia, formalisation of the decisions relating to the design of the each of the funds managed by the MC, the setup of its characteristics in terms of liquidity and calibration of liquidity management tools (e.g. redemption period, liquidity tools, etc.) as well as the factors to be taken into account and procedures for use and monitoring of use of liquidity management tools.

REs are expected maintain adequate and orderly records of actions relevant to the above in a way that enables the MC's compliance with the relevant legal obligations to be verified.

**INFORMATION TO INVESTORS ON LIQUIDITY RISK**

REs should ensure that KIIDs/KIDs and/or prospectuses/ offering documents/periodic reports to investors are consistently updated and include accurate, clear and complete disclosures on liquidity risks and the use of special liquidity management tools and arrangements under normal and exceptional circumstances.

***Guidelines***

**37.** The prospectus of the UCITS/AIFs shall include the information necessary for investors to be able to evaluate the proposed investment, particularly the relevant risks attached. To this end, the prospectus/offering document shall include a straightforward and coherent explanation of the fund's risk profile, including liquidity risk and the use or potential use of liquidity management tools.

**38.** Further, REs shall ensure that in addition to the synthetic indicator (in the case of KIID) or the summary risk indicator (in the case of KID), the UCITS KIID/AIFs KID includes a narrative explanation of risks which are materially relevant to each fund and which are not adequately captured by that indicator.

- 39.** Especially in the case of UCITS KIID, it is expressly provided that the narrative explanation of the risks, as set out above, shall include, among other things, liquidity risk where a significant level of investment is made in financial instruments which are by their nature sufficiently liquid, yet which may under certain circumstances have a relatively low level of liquidity, so as to have an impact on the level of liquidity risk of the UCITS as a whole.
- 40.** AIFMs have an explicit obligation to disclose to investors before investment a description of the AIF's liquidity risk management (i.e redemption rights and redemption arrangements both in both normal and exceptional circumstances) as well as any material changes. In addition, periodic disclosure to investors is expected to include information relevant to any special arrangements.

#### *RM P&P and Record Keeping*

- 41.** REs are expected to ensure that their written RM P&P provides guidance to be followed for the purposes of keeping investors informed on LRM matters. REs are expected maintain adequate and orderly records of such actions in a way that enables the MC's compliance with the relevant legal obligations to be verified.

#### **D. FINAL REMARKS**

REs should consider the guidance provided in the present circular as well as ESMA's [March 2021 Public Statement](#) relevant to the Common Supervisory Action (CSA) on UCITS liquidity risk management, against the performance of their activities.

The upcoming AIFMD and UCITS review, as indicated by the currently available *'Proposal for a Directive amending Directives 2011/61/EU and 2009/65/EC as regards the delegation arrangements, liquidity risk management, supervisory reporting, provision of depositary and custody services and loan origination by alternative investment funds'* will introduce important amendments relevant LRM. REs, are encouraged to consider the relevant proposals when setting up/reviewing their practices, policies and procedures in accordance with the present circular.

In addition, the risk/liquidity risk management activities of MCs may also be guided by other material produced by international organizations such as the IOSCO 2018 Report on Recommendations for Liquidity Risk Management for Collective Investment Schemes (FR01/2018), the 2017 ESRB Recommendation on liquidity and leverage risks in investment funds (ESRB/2017/6) and the FSB 2022 Progress Report on Enhancing the Resilience of Non-Bank Financial Intermediation.

For the purposes of enhancing transparency with regards to the use of Liquidity Management Tools in exceptional circumstances, and where there isn't an explicit requirement in the relevant legal framework to disclose information to CySEC and/or investors on the use of LMTs/special arrangements, CySEC requests REs do so, using appropriate means.

While reviewing their practices, policies and procedures, REs that identify any areas of concern are expected by CySEC to adhere to the applicable rules/legal framework and guidance in this circular and take any necessary action to ensure compliance.

Sincerely,

George Karatzias  
Vice Chairman  
Cyprus Securities and Exchange Commission

## **I. UCITS LEGAL FRAMEWORK**

### **(a) CySEC Law 78(I)-2012 which provides for the Open-Ended Undertakings for Collective Investment**

- **Section 18** - Redemption of units
- **Section 41** - Risk management
- **Section 56** - UCITS prospectus
- **Section 115** - Delegation arrangements

### **(b) CySEC Directive 78-2012-3 on the organizational requirements, the structure, the conduct of business, conflicts of interest, risk management and content of the agreement between a depositary and a management company**

- **Paragraph 2** - Interpretation- 'liquidity risk'
- **Paragraph 4(1)** - General requirements on procedures and organization
- **Paragraph 5(1)** - Resources – Accounting
- **Paragraph 6** - Control by senior management and supervisory function
- **Paragraph 7** - Permanent Compliance Function
- **Paragraph 8** - Internal Audit Function
- **Paragraph 9** - Risk Management Function
- **Paragraph 18** - Due Diligence requirements
- **Paragraph 28** - Risk management policy and procedures
- **Paragraph 29** - Measurement and management of Risk

### **(c) CySEC Directive 78-2012-13 on UCITS permitted investment limits**

- **Paragraph 4** - Transferable securities

### **(d) COMMISSION REGULATION 583/2010 implementing Directive 2009/65/EC of the European Parliament and of the Council as regards key investor information and conditions to be met when providing key investor information or the prospectus in a durable medium other than paper or by means of a website**

- **Article 8** - Explanation of potential risks and rewards, including the use of an indicator

### **(e) ESMA/CESR Guidelines on ETFs and other UCITS issues (ESMA/2014/937)**

### **(f) ESMA/CESR Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS (CESR/10-788)**

### **(g) ESMA/CESR Guidelines on Risk Management Principles for UCITS (CESR/09-178)**

### **(h) ESMA/CESR Eligible Assets for Investment by UCITS (CESR/07-044b)**

## **II. AIFM LEGAL FRAMEWORK**

### **(a) CySEC Law 56(1)/2013 on the Alternative Investment Fund Managers**

- **Article 7(2)** - Application for authorisation
- **Article 13(1)-(2)** - General principles
- **Article 16** - Risk Management Function
- **Article 17** - Liquidity Management
- **Article 20** - Delegation of an AIFM functions.

### **(b) Commission Delegated Regulation (EU) No 231/2013 of 19 December 2012 supplementing Directive 2011/61/EU**

- **Recital 59** - on the use of liquidity management tools and special arrangements
- **Article 1** - Definitions- (5) 'special arrangement'
- **Article 18** - Due diligence
- **Article 22** - Resources
- **Article 39** - Permanent risk management function
- **Article 40** - Risk management policy
- **Article 42** - Functional and hierarchical separation of the risk management function
- **Article 43** - Safeguards against conflicts of interest (risk management function)
- **Article 44** - Risk limits
- **Article 45** - Risk measurement and management
- **Article 46** - Liquidity management system and procedures
- **Article 47** - Monitoring and managing liquidity risk
- **Article 48** - Liquidity management limits and stress tests
- **Article 49** - Alignment of investment strategy, liquidity profile and redemption policy
- **Article 57(1)** - General requirements
- **Article 60** - Control by the governing body, senior management and supervisory function
- **Article 61** - Permanent compliance function
- **Article 62** - Permanent internal audit function
- **Articles 75** - General Principles (Delegation of AIFM functions)
- **Article 108** - Periodic disclosure to investors

### **(c) Regulation (EU) No 1286/2014 of the European Parliament and of the Council of 26 November 2014 on key information documents for packaged retail and insurance-based investment products (PRIIPs)**

### **(d) Regulation (EU) 2017/1129 of the European Parliament and of the Council of 14 June 2017 on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market and repealing Directive 2003/71/EC with EEA relevance**

### **(e) ESMA Guidelines On liquidity stress testing in UCITS and AIFs (ESMA34-39-897)**