SEC's Liquidity Rule: How to Bucket Your Assets

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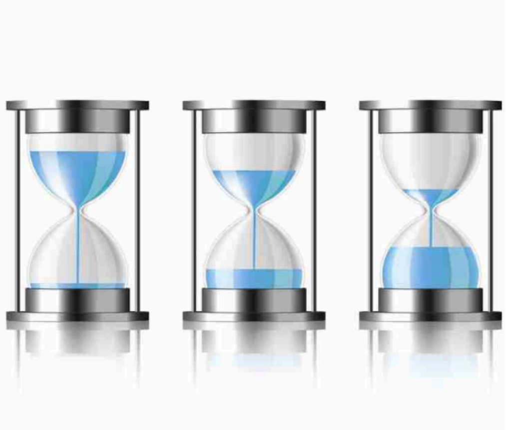

Highly liquid, moderately liquid, less liquid, and illiquid.

Classifying securities in one of those four buckets for the first time under the US Securities and Exchange Commission's new liquidity rule will force compliance and risk managers at US mutual funds and exchange-traded funds to implement new operational procedures by next year.

"Fund managers will have to clearly document the rationale for their classification choices," says Samuel Won, managing director of Global Risk Management Advisors (GRMA), a New York-based risk management advisory firm. "While the SEC's guidance leaves some room for interpretation, funds will still need to justify the reasonability of their approach."

The categorization of assets is part of a broader liquidity management program that requires monthly oversight and board approval. The board must review a report on the program's adequacy prepared by the fund's investment adviser or officer administering the liquidity program.

The goal of the new Rule 22e4 of the Investment Company Act of 1940 is to make certain that fund managers have sufficient liquid assets on hand to handle a rush of redemptions. So far, there has been no regulatory framework governing fund liquidity other than the requirement that mutual funds honor redemption requests within seven days. In addition to categorizing their assets, mutual fund and ETF managers will have to ensure that no more than 15 percent of the value of their assets is in illiquid securities and that a minimum percentage of the value of their portfolio is invested in liquid assets.

Although the SEC says that the new liquidity Rule 22e4 won't be effective until December 2018 for firms with over US$1 billion in assets under management, mutual fund managers have to submit more extensive details of their holdings to the SEC as of June 2018. That means that fund managers must complete the categorization of their assets to complete the new Form N-PORT. "It could easily take more than three months for a fund manager to prepare for the new liquidity rule," predicts Won."The new liquidity rule is much more than simply a fill-in-the-blank exercise."

The Investment Company Institute, the Washington DC trade group representing the mutual fund industry, recently asked the SEC to extend the deadline for the liquidity rule by one year and reporting by six months, but operations and compliance managers doubt the SEC will do so.

Criteria for Categorization

The SEC does offer firms some help with deciding how they should categorize their assets. It says that liquid assets are those which can be sold for cash within three calendar days, while moderately liquid are those which are convertible to cash between three and seven calendar days. Less liquid assets are saleable within seven calendar days but receiving payment can take longer than that timeframe. Illiquid instruments are not saleable within seven calendar days. When classifying the liquidity of a position, says the SEC, firms can consider the existence of an active market for the asset, frequency of trades or quotes for the asset, average daily trading volume of the asset, volatility of trading prices, bid-ask spreads, and size of the fund's position in the asset relative to the asset's average daily trading volume.

However, the SEC's pointers may not be enough. "Not all mutual funds currently take into account the number of days it would taks to convert assets to cash and those that do don't necessarily do so for all products held in a portfolio," says Joanna Fields, principal of Aplomb Strategies, a New York-based consultancy specializing in regulatory compliance. "For many firms, depending on the types of assets that comprise their portfolio, the SEC's new categorization could turn into a highly cumbersome operational project."

The reason: frameworks may exist for classifying the liquidity of fixed-income products into broader categories, such as investment-grade bonds or high-yield bonds. However, existing frameworks may not be sufficient to specify each individual product's liquidity profile down to the bond issuer, maturity and issue date, says FIelds. Over-the-counter derivative instruments also do not have generally accepted methodologies for making liquidity classifications.

The SEC's phrasing of its new rule might suggest that all the fund management firm has to do is prove it has found a ready buyer within the alloted timeframe. Not so. The SEC says that sale of the asset must not substantially change the market price of the asset during either current market conditions or "stressful" conditions. The SEC never defines what "substantially change" means nor does it explain what "stressful" means, but it is obvious that its goal is to avoid fire sales. Won offers the following example: if a firm is able to sell a liquid asset in two days, but the asset was sold with a large haircut, the SEC will most likely take exception with a fund's liquidity categorization.

Won cautions fund management firms to avoid thinking of the task of categorization as a simple back-office chore. "They need to involve risk management experts who understand liquidity management, because of the number of factors they must take under consideration to come up with a sound and reasonable decision-making process," he recommends.

Before reviewing their holdings, firms should define what they deem as non-stressed and stressed scenarios as well as determining the potential decline in the value of the asset that may occur in selling the investment in either of these two scenarios. They should also devise a workflow that includes developing liquidity calculation models and data inputs for bucketing as well as projecting the price impact from selling investment positions and converting them to cash.

Build vs. Outsource

Ultimately, a fund manager will need to decide who does the work. “Some fund management firms may have sufficient quantitative expertise in-house with existing liquidity risk models to do the categorization on their own,” says Dan Huscher, executive director of data giant IHS Markit in New York. “Alternatively, they may use a third-party to do it for them.”

For funds doing the work in-house, IHS Markit can provide data sets that fill their liquidity models or can provide liquidity models. For those relying on outsourcing, Won says that GRMA will not only do the risk calculations and assist with the categorization, but also design a liquidity risk management program that includes proper governance, policies, procedures and controls that are required by the SEC.

Regardless of which option a mutual fund manager picks, the fund is ultimately responsible for what it reports to the SEC. Hence, even if it relies on a third-party to do the work, it will still need to validate the findings on its own.

“Advisers weighing the purchase of third-party classification models also must consider how they might override such classifications,” says Erik Olsen, a director at ACA Compliance Group, a regulatory compliance consultancy in New York in a recent white paper on the SEC’s new liquidity rule. “Additionally, funds and advisers will need to determine how they will provide their portfolio holdings to vendors taking into consideration the protection of such information, including a fund’s portfolio holdings disclosure policies, as well as cybersecurity concerns.”

Advisers that rely on fund administrators to complete Form N-PORT will need to consider how they provide the administrator with the classifications. For advisers that depend on sub-advisers or others to serve as day-to-day portfolio managers, tthere also needs to be an understanding of the division of labor, explains Olsen. An adviser could push off the entire liquidity program management to their sub-advisers, delegate only the responsibility of classifying assets to sub-advisers, or share responsibility of the classification. Advisers which delegate the classification work must ensure that the sub-adviser's chief complance officer, the fund's chief compliance officer and even the adviser's chief compliance officer team up to develop and oversee classification policies.

Even the most well-prepared fund managers need to avoid the potential for error that has nothing to do with the validity of their process. They may simply decide to bucket a higher than accurate percentage of assets in the highly liquid category to attract new investors. "The SEC will be comparing the percentage of assets in the highly liquid category to the investment strategy of the fund," warns Won. "If they don't logically match up, a red flag will be raised."

If the SEC's past actions are any indication, fund managers need to be prepared that any red flag could trigger further examination and/or enforcement action, according to Won.