Major implications of the new liquidity risk management rule

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BY

Samuel K. Won

Global Risk Management Advisors

On 13 October 2016, the US Securities and Exchange Commission (SEC) adopted final new rules for liquidity risk management and rule amendments to modernise reporting. These new rules and rule amendments represent significant changes to current liquidity management and reporting requirements that will materially affect operations, reporting and disclosures at many open-end funds. Specifically, a new rule, 22e-4, requires mutual funds and other open-end investment management companies, including some exchange-traded funds (ETFs), to establish formal liquidity risk management programmes. Money market funds are excluded from all requirements of this rule and 'in-kind ETFs' would also be exempt from certain requirements.

Intent of the new rule

The new rule is intended to provide the SEC and investors with additional information and tools to monitor the ability of open-end mutual funds, and certain ETFs, to meet redemption requests without significantly diluting remaining shareholders. In addition, the SEC is hoping to more effectively collect and use data reported by funds, enhance its ability to conduct more targeted examinations, promote effective liquidity risk management across the open-end fund industry and enhance the disclosures made by funds related to liquidity and redemptions.

Given the widespread concern about liquidity, we expect many other regulators globally to adopt similar rules and regulations with regard to liquidity risk management and related reporting and disclosures.

Major requirements

As part of establishing a formal liquidity risk management programme, open-end funds will need to comply with a number of major requirements including: periodic review, assessment and management of liquidity risks; classification of portfolio investments into liquidity categories; and determination of a minimum percentage of net assets that must be invested in highly liquid investments. The SEC also adopted a 15 percent limitation on open-end funds' illiquid investments. Furthermore, to ensure that funds have 'true governance' for their liquidity risk management programmes, the SEC mandated that a fund's board will be required to review and approve its liquidity risk management programme, and, that funds designate an officer or adviser to administer their liquidity risk management programme.

In the event a fund either exceeds the 15 percent limit on illiquid investments or falls below its minimum threshold for highly liquid investments, it will be required to file a new Form N-LIQUID with the SEC. In addition, under the 1940 Act, the SEC also adopted amendments to Rule 22c-1 to permit 'swing pricing' under certain circumstances. In some cases, swing pricing would allow the adjustment of the net asset value (NAV) of a fund's shares for trading and other costs related to the purchases or redemptions of fund shares to shareholders.

Reporting modernisation

As a part of reporting modernisation, the SEC adopted a new Form N-PORT that requires registered investment management companies and certain ETFs to electronically report portfolio information on a monthly basis to the SEC. In Form N-PORT, a fund will be required to report the liquidity classification of each of the fund's positions in a portfolio investment and identify its highly liquid investment minimum.

Additionally, the new Form N-CEN requires all registered investment companies and money market funds to provide "census type" information to the SEC on an annual basis. Specifically, the SEC includes in N-CEN reporting questions related to lines of credit, inter-fund lending, inter-fund borrowing and swing pricing – of which the agency believes will help them assess a fund's liquidity position.

Key compliance dates

For fund complexes with $1bn or greater in net assets, the compliance date for liquidity risk management is 1 December 2018. For funds with less than $1bn in net assets, the compliance date is 1 June 2019.

For N-PORT and N-CEN reporting, funds that have net assets of $1bn or greater will be required to begin their filing after 1 June 2018, while funds with less than $1bn in net assets will be required to begin filing Form N-PORT after 1 June 2019.

Major strategic, operational and risk management implications

Many funds will face tremendous challenges in meeting the new liquidity risk management rule and reporting requirements because they currently lack the necessary infrastructure – both people and systems – as well as the risk management expertise, governance and associated processes and controls to implement these rules in a proper and effective manner.

In fact, a leading fund administrator which surveyed over 100 major global asset and alternative asset managers about their readiness for this new rule and reporting requirements found that 67 percent of asset managers expect the new rule to pose major implementation challenges with regard to additional board reporting and oversight, and the addition of new disclosures and reporting requirements.

Furthermore, 76 percent of respondents said more education would help them implement these changes and over 38 percent of asset managers plan to invest in new technology to try to address these changes.

Strategic implications

The new liquidity risk management rule may force some funds to offer products with higher liquidity and a much lower risk profile to comply with the SEC's new rule. Tactically, funds may choose to use an ETF structure for some of their products to avoid the new liquidity risk management rule and reporting and disclosure requirements.

Risk management and operational implications

Currently, many funds lack the necessary internal capabilities to properly implement these new complex liquidity rules and perform the ongoing reporting. Therefore, these funds will likely need to hire risk management staff or engage an external risk management adviser to meet all of these challenging requirements. In addition, funds may need to acquire specialised systems and software to perform the requisite liquidity-related cash flow and stress testing analysis and monthly reporting and other disclosures.

The many funds that still do not have a formal and proper governance structure for risk management and the requisite risk management processes and controls will likely be 'exposed' to their regulators and their investors as a result of these new regulations.

Major strategic, operational and risk management implications

Due to the cumulative effects of various regulations coming to the fore, post the 2008 financial crisis, these new liquidity risk management rule and reporting requirements will just 'add to the pile' in terms of the time, staffing and monies that will be needed to be spent on all compliance-related matters. As a direct consequence of these new regulations, new types of liquidity information will need to be incorporated into marketing and disclosure materials and it will also become imperative that these kinds of documents will need to be checked and validated to ensure that liquidity information is accurately portrayed and consistent across all documents, both internal and external.

Recommendations

There is little doubt that the new liquidity risk management rules will have a profound impact on many funds' existing operations and their business strategy, as well as for the products that funds offer in the future. The new regulations will not only greatly influence the way fund managers interact with their clients, but also in the kinds of risk transparency funds provide to them. Therefore, we strongly recommend that funds not delay in assessing their preparedness to fully meet these challenging new requirements. Furthermore, we recommend that before a fund begins any implementation work, it should first ascertain the specific implications that these new rules may have for their business and their offerings. Finally, we advise that a fund should assess whether the optimal choice is to do this work internally or if it is better served by using an external and independent risk management adviser.

Samuel K. Won is the founder and managing director of Global Risk Management Advisors. He can be contacted on +1 (212) 230 1610 or by email: swon@grmainc.com.

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