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Parsing the SEC's Liquidity Risk Management Rule

Interview with Nathan Greene

In October 2016, the SEC issued its final rule reforming how registered funds manage liquidity risk. To help with IDC's efforts to educate fund boards about the rule and their responsibilities under it, Nathan Greene, partner at Shearman & Sterling LLP, sat down for a conversation with *Board Update*. The transcript has been lightly edited for length and clarity.

Board Update: Nathan, thank you so much for being with us today. As you well know, the fund industry can expect major changes when the SEC's liquidity risk management rule goes into effect beginning in December of next year. In your view, what will be the most important change?

Nathan Greene: I'd say the most important change will be the requirement that registered open-end funds—including ETFs—establish and maintain a liquidity risk management program, which is basically a package of procedures and reports intended to help a fund stay liquid and meet shareholder redemptions.

BU: We've heard people calling this the "bucketing" rule.

Greene: Yes, that's a reference to a big part of the liquidity risk management program, and it certainly has gotten a lot of press. Funds will be required to classify their positions into four liquidity buckets—highly liquid, moderately liquid, less liquid, or illiquid. Funds will report this information to the SEC every month, so it's going to be a serious operational exercise.

BU: What should fund boards know about the classifications?

Greene: A good first thing to think about is who will do the actual classifying—outside vendors or in-house staff—and how they will do it. Also, because elements of the classification data will be made public, it's important to consider whether that will lead to any public relations risks or opportunities.

BU: Will funds still be limited to holding 15 percent of their net assets in illiquid assets?

Greene: Yes, that's still the case. But the rule sets a new test for illiquidity. Rather than looking at whether a trade in a single trading lot can be made smoothly and efficiently, which is a common compliance test today, a fund will have to consider whether it needs to trade the position "in size." So, if a larger trade in a position is reasonably anticipated—and if that trade is expected to significantly affect the market price—the position could be considered illiquid. Funds experimenting with the new test are finding—predictably—that it can raise the percentage of assets in their portfolios that qualify as illiquid. This is definitely something that boards need to understand.

BU: What else should boards know about liquidity risk management programs?

Greene: Well, three other requirements stand out for me: conducting a risk assessment, determining a "highly liquid investment minimum," and reporting liquidity breaches.

BU: Let's take those in turn.

Greene: Sure. Under its liquidity risk management program, a fund has to assess its liquidity risk, defined in terms of whether it can meet redemptions without—and these are the SEC's words—"significantly diluting" the interests of remaining shareholders. That assessment really guides the rest of the liquidity risk management program.

The first step, where most firms are today, is to decide who at the firm will help carry out the assessment. Firms are organizing cross-functional teams, with support from professionals in finance, portfolio management, trading, law, and compliance—and also from outside vendors, such as custodians and administrators.

Once roles are worked out, a firm is likely to focus on figuring out what information it needs to make the risk assessment, how management will get that information, and how the information can be translated into useful findings. Inputs will include shareholder purchase and redemption analysis, market and portfolio risk models, and, for ETFs, share and creation unit trading data.

As the process moves forward, boards will expect feedback from management on whether portfolio changes or new sources of liquidity—such as expanded or dedicated borrowing lines—are needed to improve a fund's risk profile.

BU: You talked about defining liquidity risk in terms of avoiding "significant dilution" of remaining shareholders' interests. What does that mean?

Greene: The phrase is given only loose meaning in SEC guidance so far, so firms might be on their own in considering what constitutes significant dilution and how that will be benchmarked.

I should point out that the SEC has signaled that it wants firms to ask themselves whether some funds simply should not offer daily redemptions. Funds that the SEC thinks could need a special look are those with highly concentrated portfolios or large holdings in instruments with extended settlement periods, such as leveraged loans. This is a high-level question, so boards should not be surprised if management asks them to weigh in on it.

BU: What about the highly liquid investment minimum? What's that, and what's the board's role?

Greene: Under this requirement, a fund must determine the minimum percentage of its net assets that can be converted to cash within three business days. The minimum is required for most funds, but not those with a portfolio that the rule considers to be "primarily highly liquid." As one example, a large-cap equity fund is highly liquid in the normal course and shouldn't need a specific minimum.

The role of the board changed during the rulemaking process. In the proposal, the board had to directly approve the minimum percentage for each fund. In most cases, however, the final rule requires only initial approval for the liquidity risk management program as a whole, generally without separate approval of the minimum. That's a welcome change. It also better fits with the SEC's stated view that the board's role in all elements of the rule should be one of "oversight," as opposed to something more hands-on.

BU: Okay, so how will boards oversee the minimum?

Greene: Boards first need to understand how management conceptualizes the minimum. There are a number of factors at play here: the considerations that will go into setting the number, whether the number will generally be static or more responsive to changing circumstances, which assets count toward the minimum, and whether those assets are an integral part of the portfolio or handled separately, just to name a few. Expect regular reporting, too.

BU: That leaves us with breach reporting.

Greene: Yes, funds will be required to report to boards if they breach their 15 percent illiquid limit or if they breach their highly liquid investment minimum. Funds will also file parallel breach reports with the SEC.

Boards will want to set expectations for these reports ahead of time. Directors will want to know who from management will prepare the reports, what the reports will say, and who will lead any board response. Management also should assure the board it has considered questions the SEC might ask about a breach report and that it is prepared for any possible question.

BU: With the new presidential administration in Washington, DC, and with some new commissioners soon to be at the SEC, is there any chance that the rule will be changed or delayed?

Greene: Anything's possible, but I haven't heard that the rule is on a priority list to revisit.

BU: Any last words before we let you go?

Greene: Don't be lulled by the two-year implementation period. Getting ready to implement the rule will require a lot of work. Funds should be engaged in preliminary planning now.