ENHANCED SEC OVERSIGHT:
• LIQUIDITY RISK MANAGEMENT PROGRAMS
• REPORTING MODERNIZATION

New rules warrant urgent strategic responses from asset managers

CAPCO

AT A GLANCE

Liquidity Risk Management Programs and Reporting Modernization

THE RULES

In October 2016, the U.S. Securities and Exchange Commission (SEC) voted to adopt three legislative changes to the Investment Company Act of 1940:

1. **Fund Liquidity Risk Management Programs** (new rule 22e-4)
2. **Investment Company Reporting Modernization** (new and amended forms)
3. **Investment Company Swing Pricing** (amendments to rule 22c-1)

> The Liquidity Risk Management Programs rule sets the compliance date for larger fund companies ($1 billion or more in net assets) as **December 1st, 2018**, while smaller fund companies have until **June 1, 2019** to comply. The Investment Company Reporting Modernization rule phases the compliance dates, starting on **June 1st, 2018, finalizing in 2019.**

THE RATIONALE

Collectively, the rules seek to improve consumer protection for investors in open-end registered investment companies, mutual funds and open-end exchange traded funds (ETFs). The greater protection derives from enhancing a fund's ability to meet redemption requests, without significantly diluting remaining shareholder value. Tactically, funds are required to build a comprehensive liquidity risk management program, including codified liquidity requirements. They must also adhere to a new data-driven set of reporting requirements. In addition, the use of swing pricing is permitted.

THE REQUIREMENTS

These new rules pose significant operational and strategic implications for asset managers. As with any new regulation, they also carry the potential to create litigation risk. Compliance requires substantial investment in the development and implementation of a liquidity risk management framework. Stipulations include robust portfolio accounting tools to classify and monitor fund positions, together with sourcing of data feeds to populate new and amended reporting forms.

THE ROAD TO COMPLIANCE

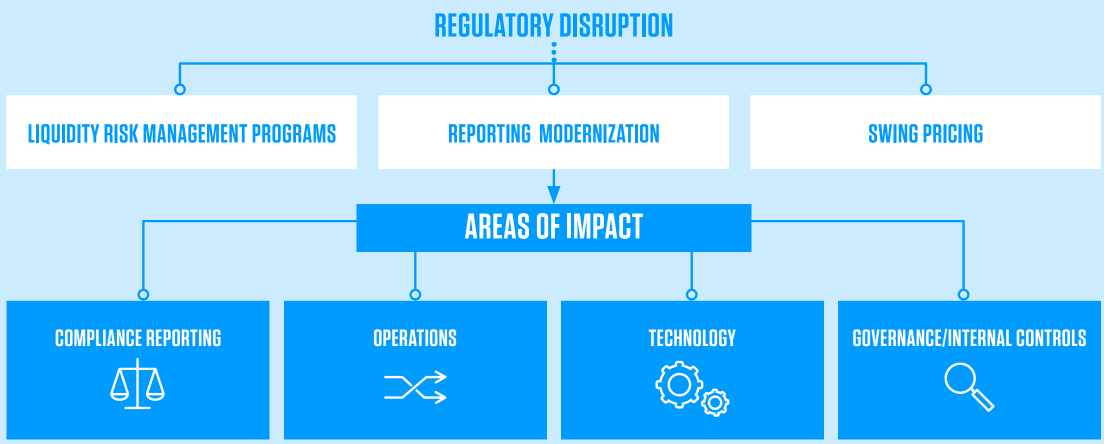
Asset management firms need to scrutinize their current practices, specifically in the key areas of compliance reporting, operations, technology, governance and internal controls. They must understand the rule changes and their individual and collective impact. Firms must respond strategically, and fast.

THE REALITY

Asset management firms' costs will increase along with management (and board) time required to achieve effective and controlled compliance. In addition, it is anticipated that no existing asset management technology system supports the requirements imposed by the new rules. Ultimately, these three rules may impact the industry by altering the mix of products offered. This will happen if asset managers respond by shifting away from less liquid investments.

INVESTOR PROTECTION

driven by new regulation of asset managers and open-end funds



LIQUIDITY RISK MANAGEMENT PROGRAMS

Rule 22e-4 requires open-end mutual funds and exchange-traded funds (excluding money markets) to address gaps and improve current liquidity risk practices. As adopted, the final rule defines liquidity risk as: "the risk that a fund could not meet requests to redeem shares issued by the fund without significant dilution of remaining investors' interests in the fund." By specifically introducing a detailed, security-level risk assessment methodology, together with minimum liquidity thresholds and board oversight, the SEC intends to enhance consumer protection. The compliance date for larger fund companies ($1 billion or more in net assets) is December 1st, 2018, while smaller fund companies have until June 1, 2019 to comply.

Key elements of the rule:

- Liquidity risk assessment
- Liquidity classification
  - 15% limit on illiquid assets
  - Highly liquid investment minimum requirement
- Board oversight

LIQUIDITY RISK ASSESSMENT

All mutual funds and open-end EFTs (with the exception of money market funds and unit investment trusts - UITs) must establish a liquidity risk management program. The program must have the aim of strengthening current liquidity risk management practice and disclosure requirements, as well as heightening transparency. Complying with this rule requires firms to periodically review, assess, and manage their liquidity risk. They can achieve this by developing and implementing a written liquidity risk management framework for each fund. Policies and procedures should include in their scope the liquidity assessment factors that are considered to influence a fund's overall liquidity risk (i.e. investment strategies, position liquidity, cash flow projections and holdings of cash or cash equivalents).

LIQUIDITY CLASSIFICATION

Funds are required to classify each portfolio position into one of four categories. These are based on the number of days in which a fund reasonably expects to be able to convert the investment into cash, without significantly changing the security's market value. While doing so, funds must, according to the SEC, take into account relevant "market, trading, and investment-specific considerations".

Within the scope of the rule, funds must review their liquidity classifications at least once a month. Robust portfolio accounting tools may assist in effectively classifying and tracking the positions into one of the following defined liquidity buckets:

Highly liquid investments: Investments reasonably convertible into cash within three or fewer business days.

Moderately liquid investments: Investments reasonably convertible into cash in more than three, but fewer than seven calendar days.

Less liquid investments: Investments reasonably closed out within seven calendar days, but where the investment will not settle until after the seventh calendar day.

Illiquid investments: Investments that cannot reasonably be sold, closed out, or otherwise disposed of within seven calendar days.

15% limit on illiquid assets

Additionally, the final rule codifies the pre-existing 15% illiquid guideline established by the SEC. This prohibits a fund from acquiring an illiquid investment if, immediately after the acquisition, the fund would have more than 15% of its total assets in illiquid investment.

If a fund breaches the 15% threshold on illiquid assets, its managers are required to take remedial measures. They should privately report to the SEC on the N-LIQUID form and notify the board.

Highly liquid investment minimum requirement

Funds that do not primarily hold highly liquid assets must define, document and maintain records of their own highly liquid investment minimum. A periodic review is required, on an annual basis. This review must include an examination of each liquidity assessment factor considered in establishing the minimum.

Compliance with the rule also requires funds to document policies and procedures setting out their response to a shortfall in highly liquid assets. A fund is permitted to operate in breach of its minimum. But any breach must be reported to the SEC on the N-LIQUID form. In addition, the board must be notified. If the breach lasts for more than seven consecutive days, the board and the SEC must be notified again, on the following business day.

BOARD OVERSIGHT

The SEC rule requires the fund's board to exercise general oversight of the liquidity risk management program. They must also act with reasonable business judgment on behalf of the investors. In addition to the initial written liquidity risk management program, the board is required to approve designation of administrative responsibilities. The board must, on an annual basis, review a written report documenting the highly liquid investment minimum and any material changes to the liquidity risk management program.

REPORTING MODERNIZATION

The Investment Company Reporting Modernization (ICRM) rule fundamentally changes the reporting landscape for mutual funds and exchange traded funds. ICRM introduces new monthly and annual reporting forms for registered investment companies, as well as amendments to existing fund documents. This greatly increases the amount of data investment companies are required to submit to the SEC. The overarching goal of this rule is to increase the amount of fund information available. The additional information allows the SEC to enhance investor protection and to identify potential "problem" funds. This more comprehensive reporting standard imposes a significant burden on investment companies. It means they must closely examine both their data sourcing and reporting processes to satisfy new form requirements. Compliance dates are phased, starting on June 1st, 2018, finalizing in 2019.

N-PORT

A new monthly form - N-PORT - is replacing the current N-Q form. N-PORT provides the SEC with information on assets and liabilities, portfolio-level risk metrics (asset liquidity classification as per Rule 22e-4) and cash flow data.

N-CEN

The N-CEN is a new annual form that replaces the current N-SAR form. N-CEN provides the SEC with census-type information, lines of credit and fund borrowing or lending information.

FUND DOCUMENTATION AMENDMENTS

Fund financial statements and registration documents will need to be updated to comply with new rules concerning disclosures, particularly those surrounding derivatives and securities lending.

REPORTING MODERNIZATION CONTINUED

Reporting Modernization Overview

	N-PORT	N-CEN	FUND DOCUMENTATION AMENDMENTS
MAIN REQUIREMENTS	• Monthly reporting of portfolio and position data, with every third fiscal month submission published publicly • Risk metrics related to credit and interest rate risk • Information regarding derivatives usage, repurchase and reverse repurchase agreements, securities lending • Asset liquidity classification (LRMP rule 22e-4) • XML format	• Annual reporting of census-type information regarding the fund • Lines of credit, inter-fund borrowing/ lending, and swing pricing • ETF-specific questions surrounding in-kind creations/redemptions • XML format	Revision and updating of fund documents with impacted areas including: • Outline of LRMP • Swing price usage/redemption procedures • Derivatives use • Securities lending activities
FUND TYPES AFFECTED	Registered management investment companies or ETFs organized as UITs, not including money market funds or small business investment companies	All registered investment companies	All registered investment companies
PREVIOUS FORM	N-Q	N-SAR	-
COMPLIANCE DATE	• Fund complexes with net assets greater than $1 billion: June 1, 2018 (without LRMP sections) and Dec. 1, 2018 (with LRMP sections) • Fund complexes with net assets smaller than $1 billion: June 1, 2019	• Fund complexes with net assets greater than $1 billion: June 1, 2018 (without LRMP sections) and Dec. 1, 2018 (with LRMP sections) • Fund complexes with net assets smaller than $1 billion: June 1, 2018 (without LRMP sections) and June 1, 2019 (with LRMP sections)	• N-1A: June 1, 2017 (liquidity sections) and Nov. 19, 2018 (swing pricing) • Regulation S-X and securities lending disclosures in Forms N-1A, N-3, and N-CSR: Aug. 1, 2017 and Nov. 19, 2018 (swing pricing)

Reporting Modernization Impact

PEOPLE

With the increased filing frequency of N-PORT and the enhanced requirements for both N-PORT and N-CEN, staff in reporting function roles will likely be overburdened and ill-equipped.

PROCESS

New operational processes are needed, and existing ones will have to be amended. Compressed timelines for N-PORT will drive the need for accelerated timelines and workflows in order to meet submission deadlines.

TECHNOLOGY

Collecting and validating all the data needed for both forms will be difficult because of the lack of a single source for all necessary items. Engagement with external data providers will likely be required, and internal systems may not be able to handle the firm's needs in their current state.

SWING PRICING

WHAT IS SWING PRICING?

Swing pricing is the practice of adjusting a fund's net asset value (NAV) to pass on the cost of purchases/redemptions to the shareholder conducting the transaction, when an established breakpoint is exceeded. The breakpoint threshold is based on trading activity (net purchases / redemptions) that generates material liquidity impacts or transaction costs for the fund.

HOW IS THE SWING PRICE FACTOR CALCULATED?

1. **Near term costs:** Costs from fees / charges arising from redemption and purchases.
2. **Asset value:** Value of redemption and purchases that occur on the day of the swing.

BOARD APPROVAL

The SEC requires board approval of the fund's swing pricing policies and procedures, as well as that of the defined swing factor used each time a threshold is exceeded.

CHALLENGES OF SWING PRICING

- Establishing swing price thresholds requires significant leadership consensus.
- The operational burden falls on fund accountants to implement different NAV calculations for the days swing pricing is triggered.
- Legal and compliance functions are required to develop and document policies and disclosures.
- Funds are obligated to submit their swing pricing policies to the SEC on Form N-1A and to investors on the fund's financial statements.

BENEFITS OF SWING PRICING

- Swing pricing protects the fund from the costs of investment/disinvestment resulting from investor activity and helps preserve investment returns.
- Funds that apply swing pricing show superior performance over time, compared to funds that do not employ anti-dilution measures.
- Swing pricing acts as a deterrent to short-term speculative investors. For any gain to be realized, their investment needs to potentially increase by more than twice the value of the swing factor.

WHAT IS THE IMPACT FOR ASSET MANAGERS?

As with any new regulation, these SEC rules present significant operational and strategic implications to asset management firms. As is common with other new regulation, they have the potential to create litigation risk. The SEC has defined clear compliance dates. They began accepting test submissions in September 2017, to enable firms to address issues that arise before actual submissions are required in mid-2018. As the SEC is already expending time and resources to ensure readiness, firms should expect little or no leeway when it comes to deadlines and accuracy of filings. Fulfilling the requirements set out by the rules requires cross-functional business support, updated policies and procedures and investment in system architecture that spans reporting, operations, technology, and governance functions. Actions for each of these areas are outlined below.

REPORTING

- **New data sourcing:** Source and structure new data elements for consumption, enabling the reporting functions to populate the new and updated reporting forms (for example, an estimated 20% of N-PORT's requirements demands new data elements).
- **Coordination between business functions:** Reconcile data across all internal systems (including trade management, fund accounting, security lending, finance, collateral management, client marketing, and security master files). This will be necessary to verify accurate and consistent reporting.
- **New reporting requirements:** Structure new and amended forms in updated formats and establish dissemination of reports at new timing intervals.
- **Disclosures:** Update client-facing marketing reports and disclaimers.

OPERATIONS

- **Liquidity risk management framework:** Develop, document and implement a liquidity framework that is both defendable and tailored for each fund. As funds are obligated to take into account relevant "market, trading, and investment-specific considerations," they must be cognizant of current market dynamics, position concentrations and net flows of distributions and redemptions. These factors may impact a fund's liquidity level, particularly when executing transactions to open or close large positions. The new framework definition outlined by the SEC may affect the way funds implement their investment strategies.
- **Ambiguity:** Apply additional scrutiny. Some sections of the final rule are ambiguous in their nature. However, they will still require clear definition and documentation, to ensure a successful - and secure – implementation.
- **Human capital:** Allocate appropriate resources to monitor and maintain liquidity risk management practices. These include verification of bucket classification, data outputs, reports, dashboards, and vendors.

TECHNOLOGY

- **System architecture:** Review and update system architecture. The objective is to define the process by which data elements will populate forms, reports and dashboard calculations across impacted applications.
- **Application limitations:** Assess the capabilities of existing technology to meet the requirements set by the new rules. Explore possibilities to enhance current applications, build new applications, or partner with outside vendors, as needed. It is anticipated that no existing system specifically supports the liquidity risk management program and associated reporting modernization activities and requirements.

GOVERNANCE AND INTERNAL CONTROLS

- **Oversight:** Define board governance and escalation processes. Define oversight processes for appointed program administrators to enable a review of the liquidity risk management program (LRMP).
- **LRMP Committee:** Structure and define the sequence of recurring meetings to periodically discuss and review the liquidity risk management program.
- **Vendor governance:** Develop a methodology to review and approve any activities proposed for outsourcing. This is crucial, as the asset manager, not the outsourcing partner, continues to be the party accountable to the SEC.

WHAT IS THE IMPACT FOR ASSET MANAGERS? CONTINUED

ALL THREE RULES WILL INCREASE COSTS FOR FIRMS

The increased costs will occur primarily in non-revenue-generating areas such as compliance, operations, and technology. Additional resources will also be needed to increase capacity and to cope with the burden imposed by compliance related activities. These include monthly N-PORT filing and liquidity classification reviews, for new and existing securities. In addition to increased business-as-usual resource costs, firms can also expect an increase in resource requirements during the transition to a compliant model.

NEXT STEPS

Asset managers need to assess the specific impact on their business. They must identify strategic options available for the best compliance response to SEC legislation. With such a considerable workload ahead, it is imperative to start immediately.

ACT NOW

The SEC rules are likely to withstand the political shift. Jay Clayton (SEC Chair) stated that he is in favor of improving capital information. This is clearly an outcome that reporting modernization strives to achieve. Given the increased operations and technology complexities that will ensue, firms should urgently prioritize dealing with the rule changes. Timely and well-planned action is imperative now, in order to successfully meet the 2018 compliance dates.

FOCUS ON OVERALL IMPACT

Asset management operations are impacted broadly and deeply. This makes it vital to understand the functional areas most affected by each of the three rules.

- Assess the impact on the firm that will derive from all the changes, taken together.
- Work holistically, prioritizing responses that address what is needed to achieve compliance today.
- Focus on liquidity risk management and reporting modernization. (These two rules are mandatory while swing pricing remains optional).
- Identify functional areas that are both directly and indirectly impacted by the rules before exploring possible solutions.

RESPOND STRATEGICALLY

A well thought through strategic response should include a number of considerations. First, any potential solution should respond appropriately to the new needs of each impacted functional area. Second, existing partnerships should be leveraged, and potential new ones explored, where partner firms offer expertise, capability, or capacity. Third, the solution needs to be practical and executable within the timeframes defined by the SEC.

- Enhance functional capabilities within your fund accounting and administration services.
- Assess your reporting capabilities to determine whether outsourcing the creation and delivery of new and adjusted reports makes long-term business sense.
- Give serious consideration to partnering with outside help if capacity and expertise become exhausted internally.

REFERENCES:

https://www.sec.gov/rules/final/2016/33-10233.pdf

https://www.sec.gov/rules/final/2016/33-10231.pdf

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