IMPLICATIONS OF THE SEC’S NEW LIQUIDITY RULE

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On Thursday, October 13, 2016, the U.S. Securities and Exchange Commission published its final Liquidity Risk Management rule (Rule 22e-4). The rule is meant to provide the SEC and investors with additional tools and information to monitor the ability of an open-end mutual fund or exchange-traded fund (ETF) to meet redemption requests without significantly diluting remaining shareholders.

In our opinion, relative to the proposed rule published in September 2015, the final rule does a better job balancing the overarching regulatory objectives with practical implementation considerations. It appears to be more workable and adopts a more principle-based, and less prescriptive, approach in many areas, in particular giving funds greater discretion around how to classify the liquidity of assets and set the minimum percentage of highly liquid assets that must be maintained. In addition, while the rule is clear that boards must remain involved, it reduces the burden they will experience; boards are responsible for general oversight of the program, but they are not responsible for approving the fund’s highly liquid investment minimum (HLIM) or approving material changes to the program.

Rule 22e-4 has significant operational and strategic implications for asset managers. It increases fixed costs, requires a significant investment of management and board time, raises questions about product structure, shifts the mix of desirable business away from less liquid underlying investments, and like any new, complex regulation, it has the potential to create litigation risk. The rest of this memo explains the new final rule and lays out the implications for business strategy.
WHAT ASSET MANAGERS NEED TO KNOW

The new rule applies to all open-end mutual funds and ETFs, excluding money market funds. Large entities ($1 billion) need to comply by December 1, 2018; fund complexes with less than $1 billion in net assets need to comply by June 1, 2019.

The rule requires each registered open-end fund to adopt and implement a written liquidity risk management program, overseen by the fund’s board, that formalizes a process for assessing, managing and periodically reviewing the fund’s liquidity. Specifically, this entails:

1. Classifying and monitoring the liquidity of each of the fund’s investments;

2. Determining the minimum percentage of highly liquid investments (investments that can be converted to cash within three days) the fund must maintain and periodically reviewing it; and

3. Ensuring that investments in illiquid assets do not exceed 15 percent of total net assets of the fund

In conjunction with the Liquidity Risk Management rule, the SEC released two additional regulations: the first specifies new reporting requirements mandating that funds provide additional information to the SEC and disclosures to investors regarding fund liquidity. The second formalizes how funds can use “swing pricing” to impose the cost of trading activity on those shareholders that are making purchases or requesting redemptions.
KEY ASPECTS OF THE RULE AND OUR TAKE

1. LIQUIDITY CLASSIFICATION

DETAILS OF RULE
• Each asset must be classified as highly liquid, moderately liquid, less liquid, or illiquid
• Classification can be based on asset class unless a particular investment has characteristics that differ from the fund’s holdings in that asset class
• Specific classification factors are now guidelines, not specific requirements

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• The final rule is simpler than the proposed rule, with four levels of liquidity buckets instead of six, the ability to classify at the asset class level and removal of the requirement to use specific liquidity factors
• Despite the changes, however, it will require significant resources and investment to perform the necessary classifications, conduct the ongoing monitoring, and meet the new reporting standards

2. HIGHLY LIQUID INVESTMENT MINIMUMS

DETAILS OF RULE
• Each fund must determine a minimum percentage of its net assets that will be invested in highly liquid investments (“HLIM”)—those easily convertible into cash within three days
• If a fund’s percentage of highly liquid assets falls beneath the HLIM, it will still be allowed to purchase securities that are not highly liquid, but funds are required to adopt shortfall policies and procedures to govern this process

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• Firms will need to develop new or enhanced analytical approaches and tools (cash flow models, redemption forecasting, etc.) to determine appropriate HLIMs
• Drafting shortfall procedures will add to operational and governance burdens
• The ability to purchase assets that are not “highly liquid” when below HLIM is beneficial, but investment returns could be impacted if the existence of HLIMs causes investment teams to alter their strategies

3. ILLIQUID INVESTMENT LIMITS

DETAILS OF RULE
• A fund may not acquire any illiquid investment that would cause its total illiquid assets to exceed 15 percent of net assets
• Definitions of illiquid assets and what were previously called “15 percent standard assets” are now the same
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• Harmonization of the definitions between illiquid assets and 15 percent standard assets eliminates inconsistencies and reduces scope for confusion and manipulation as compared to the original proposal
• The 15 percent illiquid asset maximum is a hard limit that if exceeded, will trigger a confidential notification to the SEC

4. CONSIDERATION OF FUND STRUCTURE

DETAILS OF RULE

• Funds are explicitly required to consider whether an investment strategy is appropriate for an open-end fund

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• This is a new provision that was not in the proposed rule. It raises the question of whether focused strategies using less liquid assets or instruments (for example, leveraged loans or certain restricted securities) remain viable in an open-end fund structure at all

5. ETF EXEMPTIONS

DETAILS OF RULE

• ETFs that use in-kind redemptions are exempt from the liquidity classification and HLIM requirements

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• This is a significant change from the proposed rule. Because most ETFs use in-kind redemptions, the exemption effectively applies to the entire ETF industry
• By removing two of the most operationally and methodologically burdensome provisions of 22e-4, in certain cases, this may make an ETF structure more attractive than a mutual fund structure

6. SWING PRICING

DETAILS OF RULE

• The rule permits, but does not require, swing pricing, which allows funds to adjust their net asset values to pass on to purchasing or redeeming shareholders the costs associated with their trading activity

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• Swing pricing can be an effective tool to achieve the SEC’s goal of allowing funds to meet redemption requirements without diluting remaining shareholders
• While swing pricing is already used effectively for UCITS vehicles in Europe, U.S.-based funds will need to make incremental investments in the infrastructure necessary to support it

7. ENHANCED REPORTING

DETAILS OF RULE
• Funds must report breaches of the HLIM (if the breach persists for more than seven days) or the 15 percent illiquid asset limit on Form N-LIQUID. Reporting will be nonpublic
• Lines of credit and interfund lending/borrowing must be reported on Form N-CEN
• Liquidity classifications of each fund investment are reported on a monthly basis on Form N-PORT
• Data from the first two months of the quarter is nonpublic, month-three data is made public after 60 days

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• The nonpublic nature of some key elements of reporting provides some protection of competitive data and mitigates concerns about public misinterpretation/misuse and adverse market impacts
• The N-PORT form moves reporting from a semiannual to a monthly cadence, which will create additional administrative and operational burdens, especially for smaller funds
LOOKING AHEAD: POTENTIAL IMPLICATIONS FOR THE INDUSTRY

While it is still early days and fund companies will be digesting the details of the SEC’s new rule in the weeks and months ahead (as will we), we already see a number of potential implications for the industry. Some, such as the operational and administrative burdens created by the rule, are readily apparent. Others, such as the impact on portfolio management and the makeup of the product and provider markets as a whole, are less obvious. Here are our initial views:

PRODUCT LANDSCAPE

1. Retail investors may have reduced access to less liquid strategies. If this happens, it will be driven partly by the requirement to consider the appropriateness of each strategy’s open-end structure, and partly because increased focus on liquid assets will put the brakes on fund performance. Given the explicit requirement to consider appropriateness of an open-end structure, strategies using more illiquid assets such as bank loans, emerging market debt, or restricted securities may morph back to private vehicles accessible only to accredited/high-net-worth investors. If this were to happen, it would not only reverse the “democratization” of investment strategies for retail investors, but it also could hurt an important source of profit growth for traditional retail fund providers.

2. Funds may migrate to ETF structures. Because ETFs whose redemptions are primarily in-kind do not have to comply with the liquidity classification and HLIM requirements, the growth of both passive and active ETFs may accelerate at the expense of mutual funds. For many mutual fund firms without ETF capabilities, there will be increased pressure to either build these capabilities or buy them to quickly get the scale required.

3. Multi-asset strategies may grow even more quickly. While multi-asset strategies are already growing strongly and are expected to continue to do so, the higher HLIM requirements imposed on less liquid funds (such as bank loan or high yield funds) may make single-asset-class funds less viable. Firms that can combine less liquid with more liquid asset classes in a multi-asset strategy could provide an attractive alternative.

4. The creation of new funds may slow. Certainly the increased cost of complying with the rules additional regulatory requirements would tend to discourage the creation of new funds. Moreover, newer funds may also be inherently disadvantaged relative to funds with longer track records; without redemption data and flow history, younger funds may have to set more conservative HLIMs and suffer performance drags as a result.
5. **Funds may consolidate or close.** A liquidity risk management program is inherently complex, cutting across many different functions, including technology, risk, compliance, portfolio management, and accounting. And the new rule demands, broader and more frequent reporting—with the cadence accelerating from annual and quarterly to monthly. All these factors will increase operational expenses, making some funds on the margin unprofitable, potentially forcing closures and consolidation.

**PROVIDER LANDSCAPE**

6. **Third-party vendors may have new opportunities:** While it is unlikely that a single vendor will be able to provide a complete end-to-end liquidity risk management solution, third-party providers can help address specific elements—from data and analytics, to middle- and back-office administrative services. In particular, providers that serve as mutual fund “utilities” (e.g. fund services outsourcing firms) may take on larger roles. This will result in a lucrative opportunity for providers in this part of the value chain, and force any subscale players to consider redesigning their operating model.

7. **Small funds may be at a disadvantage:** While funds with net assets of less than $1 billion will have additional time to comply with aspects of the rule it will still hit them harder than larger firms because of the fixed costs involved. Moreover, smaller firms are likely to experience greater redemption volatility and have shorter performance histories, and thus—all else being equal—may end up needing higher HLIMs. While smaller funds may be able to reduce costs by working with outsourcing firms, the rule will likely exacerbate their structural cost disadvantages.

**MANAGEMENT AND PRODUCT DESIGN**

8. **Portfolio management may become more complex.** Investment strategies may become more complex as portfolio managers use derivatives to help overcome the cash drag in their funds, potentially leading to additional operational and investment risk. Funds that lack the technical expertise to manage this additional complexity could find themselves at a disadvantage.

9. **Products may take on higher active risk.** To the extent portfolio managers (particularly in less liquid funds) must increase cash holdings to meet HLIMs, they may find their funds structurally underperforming vis-à-vis their benchmarks in an up-market. This may cause PMs to reposition their portfolios, potentially increasing risk (via greater single name/sector concentration, small cap biases, etc.) leading to larger active risk. In some cases, maintaining current outperformance expectations will require building out products with higher tracking error and larger active risk budgets.

10. **Passive strategies may experience greater tracking error, undermining a core element of their value proposition:** Passive mutual funds tracking less liquid indices will presumably need to have higher relative HLIMs. As HLIM instruments are likely not to be in the index they are tracking (or in the same quantity), this will create higher tracking error, defeating one of the main reasons investors use passive mutual funds.
Arguably, this would be an advantage to ETFs which do not have to comply with HLIM requirements and may drive the conversion of passive open-end mutual funds into ETF structures.

ANALYTICAL AND OPERATIONAL REQUIREMENTS

11. New analytical methods and supporting infrastructure will need to be developed:

The rule requires funds to use short- and long-term cash flow projections under both normal and reasonably foreseeable stress conditions as part of managing liquidity risk and setting the HLIM. In addition, while not requiring the use of stress testing, the SEC highlights it as a particularly useful technique for managing liquidity risk. Many firms will be forced to develop new analytical methods (or meaningfully improve what they are currently using) to better assess asset liquidity and trading dynamics while better understanding redemption behavior and how that varies by fund type, shareholder structure, and distribution channel. For many firms, supporting this new level of analysis will require significant enhancements to their technological and data infrastructure.

These are just our initial hypotheses, intended to prompt questions and spark healthy internal debate. The only thing we can be sure of at this point is that some of these will be roughly on target, while others will probably be wide of the mark. We believe it is imperative for fund companies and other market participants to begin thinking about what this means for them, even if it is not possible to predict the full range of implications as firms’ response strategies are unknown and unintended consequences are inevitable. Importantly, it is not only about gearing up to ensure the new operational requirements can be met, but also thinking through how it will impact core parts of the business from portfolio management to product strategy. If Oliver Wyman’s experience in helping the banking and insurance industries comply with the wide array of new regulations promulgated since the financial crisis is any guide, we would encourage funds to begin examining these issues and assessing their degree of preparedness now.
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