IGNITES

New Year Greets CCOs With Tall Tasks Around Liquidity, Reporting, Model Oversight

By Jill Gregorie January 4, 2019

CCOs face enormous tasks entering 2019, including finalizing their liquidity programs, fine-tuning their internal processes of gathering and presenting data used in electronic shareholder reports, and refining their methods of examining the algorithms that underpin investment models.

One SEC rule in particular will dominate compliance agendas for the first half of the year, says George Raine, a partner at Ropes & Gray.

“Liquidity is going to be front and center as we roll into 2019,” Raine says.

The SEC in March postponed a handful of the rule’s requirements by six months, but left the Dec. 1, 2018, deadline in place for large firms on other provisions. The tiered deadlines have led to an “awkward” stage of compliance where firms have hammered out certain elements of their liquidity risk programs but left others “very undefined,” as reported.

Beginning in December, for example, complexes with $1 billion or more in assets have been required to have a liquidity risk management program on the books. They also had to abide by a 15% limit on illiquid investments and appoint an administrator for their liquidity program.

But for some of the most significant requirements, including placing securities into “buckets” based on how quickly they can be sold, large firms have until June 1.

Most firms have presented their liquidity risk management programs to boards but are still “nailing down how things are done internally,” Raine says.

Firms working through the in-depth procedures will likely present “fully baked” programs to boards around March, he says.

The bucketing procedures, in particular, are a work in progress, since many service providers are still determining how to integrate disparate data feeds, Raine says.

Fund sponsors are also determining how much responsibility subadvisors should have in the bucketing process, not to mention what they should do when subadvisors classify holdings differently than they do, notes Whitfield Athey, CEO of **Delta Data**, a Columbus, Ga.-based distribution consulting and software provider.

Multi-managed bond funds are most susceptible to such discrepancies, he says.

In addition to liquidity rule work, many compliance chiefs will spend the first four months of 2019 gearing up for the deadline to report monthly portfolio holdings and risk metrics to the SEC as required under the data modernization rule, Raine says.

Large firms must begin supplying these reports by April 30. Smaller firms have until 2020 to comply.

Some vendors are struggling to acquire the right data for those reports, and others are still figuring out how to properly disclose information about derivatives and the underlying terms of such contracts, as reported.

Shops are using the six-month extension granted by the SEC in December 2017 to work out these final kinks, Raine says.

“My sense is that, had the SEC not moved the original time frame, there would have been a lot of delays and errors,” Raine says.

CCOs are also ramping up for 2021, when the SEC will allow shops to switch to a “notice and access” model of electronic delivery for fund documents, provided that shops begin disclosing their plans to go paperless in 2019.

To do so, compliance chiefs are figuring out how to turn massive amounts of raw data into smaller components they can split up and customize depending on the targeted recipient, whether that’s a regulator, client or public-facing website, notes Gary Casagrande, VP of global market strategy at Confluence.

In this way, compliance will play a key role in helping firms “differentiate themselves on the way they deliver data to shareholders,” he says.

Some firms may simply put PDFs on a website, while others choose to develop mobile content that is interactive and customized to the user. Such decisions require compliance teams to work with operations to automate certain back-office functions, he says.

Another focus for CCOs is fine-tuning their processes for managing models and algorithms. The SEC’s Office of Compliance Inspections and Examinations has been probing firms’ models in routine exams, Deloitte’s 2019 Investment Management Regulatory Outlook notes**.** In doing so, regulators are paying close attention to custom-built indices, trading algorithms and robo-advice platforms.

SEC examiners are particularly checking that these models work as described in disclosures, and that they will continue to operate in the manner described in changing market conditions, the report notes.

To prepare for those exams, compliance departments should take stock of guidance put forth by the Federal Reserve System in 2011, says Clifford Goss, a partner at Deloitte Risk and Financial Advisory. Although those principles were designed for banks, investment firms can use them when developing methods to manage risks associated with models.

Those guidelines call for separating the responsibilities of developing and validating models, flagging instances when the output of a model is ignored or overridden and establishing reporting lines for employees to follow if they spot potential deficiencies during validation work.

Quant teams should also conduct internal audits to check the integrity of the risk management program, and assess whether the work of the groups responsible for verification is comprehensive and accurate, Goss notes.

Aegon’s $97 million settlement with the SEC in August should be a warning to other firms that are lax in their supervision of quants, Ropes & Gray’s Raine notes. In that case, Aegon allegedly relied on an analyst’s untested models for 15 for its investment products. The Cedar Rapids, Iowa-based company found more than 50 errors once it finally began vetting the analyst’s work.

“Investment models can go awry in situations where you have quant proxies with no human oversight,” Raine says.

The models that underpin factor investing could draw more enforcement activity in 2019, Raine says. Many firms have been trying to distinguish themselves by adding quant-driven variations to their index strategies, and the explosion of smart-beta products comes with many risks, he says.

“You can imagine that all sorts of issues could arise if an input is misplaced or if there are any computing errors,” he says.

The 2019 Compliance Calendar

Fund companies face a number of SEC rule deadlines that will take effect in 2019. Shops are also keeping an eye on rule proposals and other agency initiatives that could impact their businesses. Here's an overview of what lies ahead:

On the Books:		
Rule	**Deadline**	**Efforts Needed to Comply**
E-Delivery of Fund Docs	Ongoing through 2019, for funds seeking to rely on the rule in 2021.	Funds must notify investors of plans to switch to a "notice and access" delivery model six times before they can provide shareholder reports online by default. The process will take about two years. Funds that fail to update their disclosures must wait until 2022 to send documents electronically.
Liquidity Rule	The second phase of compliance begins June 1 for large shops. Complexes with less than $1B in assets have until Dec. 1.	Funds will need to divvy up portfolio holdings into four "buckets" based on their liquidity profiles, set highly liquid investment minimums and get final board approval for their liquidity risk management programs. They also must begin meeting ongoing board reporting requirements.
Reporting Modernization	April 30 for large shops. Firms with less than $1B under management have until April 30, 2020 to comply.	Shops will need to compile data and submit monthly reports containing their complete portfolio holdings, as well as certain risk metrics, to the SEC every 30 days.
In The Hopper:		
SEC Initiative	**Current Status**	**Next Expected Action**
Regulation Best Interest	The SEC is reviewing a set of proposals from April 2018, including one that would require brokers to operate under a "best interest" standard. Under that model, brokers would need to disclose potential conflicts of interests. In December, SEC chair Jay Clayton remarked that a "uniform advice standard" for both brokers and advisors "is not off the table."	The agency expects to release a final rule by September 2019, according to its fall regulatory agenda.
Exchange-Traded Funds	The SEC in June 2018 proposed a rule that would allow issuers to launch "plain vanilla" ETFs without first obtaining exemptive relief.	The agency plans to release a final rule by September 2019, according to its fall agenda.
Fund of Fund Arrangements	In late Dec. 2018, the SEC proposed a rule that would allow funds to invest in other funds at levels higher than current limits allow, without prior regulatory approval.	The SEC will open a 90-day comment period once the draft rule is published in the federal register.
"The Investor Experience"	When the SEC passed its E-delivery rule in June, it also set up a website seeking investor feedback on how disclosures can be modernized. The agency provided suggestions including adding audio and video elements, or personalizing content.	Investors were able to submit comments up until Oct. 31, 2018. The investment management unit is currently reviewing those submissions. It has not indicated next steps.
Fund Doc Processing Fees	In June, the SEC began looking at the processing fees that vendors and intermediaries charge for distributing shareholder documents and managing clients' preferences for report delivery.	The period for comments closed on Oct. 31. It is unclear what the agency plans do with the feedback.