PMs 'Resent' Liquidity Rule but Play Critical Role in Compliance

By Jill Gregorie June 13, 2018

Portfolio managers will play a critical role in shops' efforts to comply with the so-called "bucketing" provision of the SEC's 2016 liquidity rule, lawyers and consultants say.

Compliance and risk management teams will be relying on PMs to actively monitor the bucketing process used by fund administrators and other vendors, while also watching to ensure that liquidity scores do not influence the managers' investment process, changing the fund's structure, strategy or risk profile, they add.

Beginning June 1, 2019, large complexes will be required to classify holdings into one of four buckets, depending on how quickly each can be converted to cash.

Although portfolio managers may be among those who understand the liquidity profile of each holding best, some may be "reluctant" to aid in the bucketing process, according to Andrew "Buddy" Donohue, of counsel at Shearman & Sterling. Some may worry about being perceived as trying to make their portfolios appear more liquid than they actually are, said Donohue, who spoke at a workshop hosted by Voltaire Advisors last week.

"A lot of them are resentful that the SEC proposed this rule and are fighting the rule," says Tim Dowling, a consultant with Columbus, Ga.-based **Delta Data** in a call days after the event.

Because of their expertise, however, portfolio managers should at least be involved in quality control checks of liquidity data, says Rob Haddad, head of product strategy and innovation at ICE Data Services, one of the vendors helping with bucketing and other provisions of the SEC rule.

"The portfolio management group is an important part of validating and testing liquidity model outputs," he says.

PMs may also need to help fill in gaps, Dowling says.

"The portfolio managers are going to be able to provide insights on questions like, 'If we're going to use corporate bond data as the basis of liquidity calculations for syndicated loans, should we assume that syndicated loans are exactly as liquid as similar corporate bonds, or should we discount that? If we decide to discount it, what should that discount be?'" he says.

The rule establishes that shops must appoint a program administrator, and explicitly forbids portfolio managers from assuming that post. Still, funds can appoint a committee, and should consider including members of the PM team on it, says Dowling, the Delta Data consultant.

“The people who are the biggest experts about assets are the portfolio management team, so it would be kind of crazy to leave them out of the process,” he says.

The extent of the PM’s involvement in the process will depend on the shop, but many will likely not be engaged with “all the intricacies of the liquidity risk management program,” says Aaron Withrow, an associate at Dechert.

“In many cases, it's not very realistic to expect that portfolio managers also serve as compliance professionals,” he says.

Some portfolio managers have expressed concern that their funds will fall short of the Securities and Exchange Commission’s liquidity requirements based on data provided by a vendor that they “don’t agree with or may not even know the inputs to,” said Robert Kane, CEO of BondView, who also spoke at the Voltaire Advisors event.

Donohue, who formerly served as the Securities and Exchange Commission’s head of investment management, suggested that funds set up a “challenge system” that allows portfolio managers to flag pricing issues or identify any potential exceptions “through proper channels and with the right controls.”

But the best-designed programs involve PMs in the early stages of establishing the process and rationale behind how holdings get bucketed.

“We tend to find the risk function or liquidity function going back-and-forth with portfolio managers to make sure they can understand the approach being taken — methodology — and then reviewing output to get their opinion,” says Mark McKeon, global head of investment analytics at State Street Global Exchange.

But such conversations are likely to continue after the rule is fully in effect.

In some cases, for example, portfolio managers may disagree with risk or compliance officers about whether a global event’s market impact will be immediate, or whether it will resonate across a sector. The groups can then “have a healthy discussion” about the best approach to capturing those market events in liquidity metrics, he says.

Beyond bucketing, risk and compliance may also seek information about the fund’s redemption profile, investor concentration and available credit facilities, since those data points are also necessary for managing liquidity risks, McKeon says.

Portfolio managers may also provide insight about setting funds' highly liquid investment minimums, since they're the ones with their fingers on the pulse of the fund's risks, cash flow and other metrics, Dechert's Withrow says. The PM perspective is critical to prevent the minimum from being set too high. For example, pressure to improve a fund's liquidity profile by holding extra cash could drag on performance, prompting a PM to use the liquidity budget they do have on higher-risk securities than they may otherwise choose, he adds.

Shops must also convey the stakes of not managing liquidity properly to PMs, Delta Data's Dowling says.

"I think that senior management needs to communicate to them that this is something very important to them personally, and that it is not something that can be pushed down to the juniormost guy at the desk," he says.

The SEC could "come down hard" on an investment company that continues investing in illiquid assets for a competitive edge, and there are managers "taking advantage of that illiquidity premium more than they should," Dowling says.

"They're getting all the data, they're going to see it, and if somebody really is using illiquidity to generate returns — which is quite possible in fixed income — that's a problem and the SEC is going to make an example of somebody," Dowling says.

Lawsuits would likely follow any enforcement action related to such behavior, creating a double whammy for the business.

Fund groups should also think about asking for transparency from subadvisors, since PMs may not be able to override a liquidity classification if they don't know how the subadvisor made that holding's bucketing determination, McKeon says.

Now that the SEC has proposed allowing firms to publicly share data in a "textual form," PMs may also want to help craft the language the fund uses to disclose its liquidity risks to investors, ICE's Haddad says.

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