Shops' Plans for Classifying Holdings: Monthly, at First

By Jill Gregorie August 22, 2018

Most shops are setting monthly "bucket" classifications for their investments — but over time, most will likely switch to evaluating securities daily, lawyers and consultants say.

Doing so will be necessary to comply with the SEC's liquidity rule, the first portions of which go into effect in roughly four months. Under that rule, fund providers will be required to classify investments based on how quickly holdings can be converted to cash.

About six in 10 fund companies plan to take a monthly approach to classification, according to ACA Compliance Group's August 2018 Liquidity Risk Management Program Rule Survey. The survey includes responses from 32 fund complexes and 45 investment advisors and subadvisors. All but two of the complexes had more than $1 billion in assets.

Under the Securities and Exchange Commission rule, funds must classify their securities on a monthly basis, unless "changes in relevant market, trading and investment-specific considerations are reasonably expected to materially affect one or more of its investments' characteristics."

When such an event does occur, funds must conduct "intra-month re-evaluation," as outlined by their liquidity program's policies and procedures, the SEC's FAQs state.

As a result, many firms are "starting to move to daily" classification, says Mark McKeon, global head of investment analytics at State Street Global Exchange.

Among the entities that responded to the ACA survey, 59% of complexes say they plan to classify monthly, 13% plan to classify weekly and 25% plan to classify daily. By comparison, 62% of advisors plan to classify monthly, 8% plan to classify weekly and 24% plan to classify daily.

Many could still be undecided, and assessing the best way to comply with the rule. The deadline for the first set of requirements — including the drafting of liquidity risk management programs, adoption of a 15% illiquid investment limit and designation of program administrator — is Dec. 1, 2018, but larger firms do not need to begin classifying securities until June 1, 2019. Smaller firms with less than $1 billion in assets have until Dec. 1, 2019.

“It could be that a lot of respondents are still in the earlier implementation phases of the project, where they’re working through a lot of open questions and thinking about this from a monthly point of view,” McKeon says.

A potential complication of monthly bucketing is that funds will need to keep track of “unclassified” securities that may need additional scrutiny throughout the 30-day period, McKeon notes. That category may become large — and burdensome — over longer stretches of time, he says.

“At what point does that become meaningful, from a liquidity perspective?” he says.

In addition, monthly classification can result in “stale” data, he notes.

“Running it less frequently might seem to be the easier route, but as you get into it, you might need to update your documentation as to what sort of events will cause you to rerun classifications,” McKeon says.

The question can also depend on the fund group’s investment style, says Erik Olsen, director at ACA Compliance Group. Firms that primarily invest in broad asset classes might find daily classification easier, addressing anomalies when they arise, he says.

Conversely, funds with difficult-to-price holdings, such as foreign small-cap stocks, might face greater challenges, especially if vendors fail to produce readily available information for less liquid holdings, says John Hunt, partner at Sullivan & Worcester.

The size of the fund group is another consideration, says Tim Dowling, a consultant at **Delta Data**.

“If you have a relatively small fund, and it has nothing but S&P 500 stocks in it, you’re going to be 100% fine with a monthly classification,” he says.

Larger funds that invest in less liquid assets, including many fixed-income securities beyond Treasurys, will need more frequent bucketing “or you’re going to be violating the spirit of the rule,” he says.

Another benefit of more frequent classification is the added assurance that fund liquidity will not breach its 15% limit on highly illiquid assets, or its predetermined highly liquid investment minimum, ACA’s Olsen notes.

Some groups may choose to classify investments on a daily basis informally, and use those calculations to confirm that monthly reports are accurate, Hunt says.

In ACA’s survey, two complexes and two advisors indicated that they would take such an approach.

It could also be a matter of becoming comfortable with the rule, McKeon says. Some firms might “start out monthly, and once a solution is in place, move to a more frequent service,” he says.

Automation should help make the process manageable, he says.

“As people go through this, they’re starting to realize that once you implement a solution, it’s as easy to run daily as it is monthly,” McKeon says.

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