FUND BOARD VIEWS

Top of the Agenda - Governance

Does your firm have a game plan for liquidity rule compliance?

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By Hillary Jackson

As mutual fund directors return to the boardroom for third-quarter meetings, getting up to speed on the adviser's preparations for compliance with the Securities and Exchange Commission's liquidity risk management rule is sure to be on the agenda. Rule-related discussions restarted after the summer break are likely to include an update from various parties involved with the prep work and eventually may include considering the fundamental question of whether certain funds should even exist in a '40 Act format, according to Jeff Engelberg, managing member of Additive Advisory and Capital LLC.

Rule 22e-4 was adopted in October 2016 and is aimed at reducing risk in the fund industry. The compliance date for most fund groups is December 2018, and fund boards will need to approve the liquidity risk management program and the designation of an administrator of the program, as well as approve funds' swing pricing policies and procedures. Once the program is in place, the board will be required to regularly review the adequacy and effectiveness of both the liquidity risk management program and the swing pricing policies.

The fund board is firmly in an oversight role, both in the lead-up to implementation and once the required program is in place. This, of course, requires fund directors to understand the rule and its requirements, monitor the adviser's progress, and stay up to date going forward. Engelberg said this crucial period between now and implementation should involve a "cross-departmental team"—everyone from traders and portfolio managers to compliance professionals to fund directors. And, he said, some tough questions need to be asked.

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Engelberg and his colleagues at Additive—a Memphis-based RIA that specializes in equity derivatives, new product development, and merchant banking—have devised what they're calling a "protocol" for firms to use when approaching liquidity risk management. "The idea was to create a cross-departmental strategy to create a game plan to compliance with the rule," Engelberg told *Fund Board Views* in an interview. He explained that the protocol takes a "holistic approach" to the rule, but breaks it down into component parts and guides on how to tackle issues pertaining to specific requirements.

And while Engelberg acknowledged that different fund groups have different needs depending on how they're invested, he maintained that a certain amount of standardization is useful—and should be helpful to the industry going forward. "What we hope that we can establish with this protocol is a roadmap for firms toward compliance...all of which can adapt general questions into firm-specific questions," he said. "It's a standardized model for the industry to start a conversation."

One key question Additive addresses is the definition of a mutual fund under the Investment Company Act of 1940, and Engelberg said it's an important one to ask. "This rule, from our perspective, really goes to the heart of the value that a fund offers to its shareholders," he said. "The SEC's lead-off question is: Should this strategy exist in an open-end '40 Act format and will it protect its shareholders against excessive liquidity dilution?" Answering the question involves reviewing every aspect of the fund—including distribution channels, portfolio management, how the PM goes about selecting what the fund buys and sells, how the markets function for all of the securities in the portfolio—and determining if it's doing what it is supposed to be doing under the '40 Act. "There's an implicit sign-off obligation where the whole organization—up to the board—is saying: 'The strategy and the manager can allow this fund to exist within the confines of the '40 Act and, based on management's hard work in analyzing and reporting their liquidity thinking, we're OK with that.'"

Getting to that level of comfort is what the board should be striving for, Engelberg said. "It would be useful for board members to read through the protocol and look at the questions we're asking. ...Maybe it motivates a different board discussion."

To access a white paper on Additive's protocol, click here.

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