SEC LIQUIDITY RISK MANAGEMENT PROPOSAL: HOW FUNDS CAN PREPARE

BY JULIEN BOURGEOIS, BRENDAN C. FOX, JOHN V. O'HANLON AND AARON D. WITHROW OF DECHERT LLP

The **Securities and Exchange Commission** has proposed far-reaching changes to the way registered open-end funds—including open-end exchange-traded funds (ETFs) but not money market funds (MMFs)—assess and manage liquidity risk. The proposal will likely require firms to implement new monitoring and assessment procedures that go well beyond traditional portfolio monitoring procedures, and it may require many fund complexes to acquire new systems to implement these procedures.

The SEC proposal would:

- Require funds to adopt liquidity risk management programs with specified features;
- Permit registered open-end funds, other than ETFs and MMFs, to use so-called "swing pricing"—the adjustment of net asset value per share for purchasing or redeeming shareholders to reflect costs associated with purchase or redemption activity.

Fund boards would have to approve the personnel responsible for implementing these programs.

OUTLINE

Under the proposal, each fund would be:

- Required to classify, taking into account specified factors, referred to herein as "classification factors," its portfolio positions, or portions thereof, into one of six liquidity categories and review such classifications on an ongoing basis;
- Required to assess and periodically review its liquidity risk, taking into account specified factors, referred to herein as "risk factors;"
- Required to determine a minimum percentage of net assets, referred to herein as "TDLA minimum," that must be invested in three-day liquid assets, or TDLAs, and review the TDLA minimum semi-annually;
- Prohibited from acquiring non-TDLAs if the TDLA minimum would be exceeded immediately after such acquisition;
- Prohibited from acquiring any asset that may not be sold or disposed of in the ordinary course of business within seven calendar days at roughly the value ascribed to it by the fund (called a "15% standard asset") if, immediately after such acquisition, the fund would have invested more than 15% of its assets in 15% standard assets. This is referred to herein as the 15% prohibition.

Under the proposal, a fund would be permitted to use swing pricing if it has established and implemented policies and procedures that:

- Provide that the fund must adjust its net asset value by an amount (known as the "swing factor") once the level of net purchases or net redemptions exceeds a specified percentage of the fund's NAV (know as the "swing threshold");
- Establish the swing threshold, and provide for its periodic review no less frequently than annually, taking into account specified factors;
- Establish how the swing factor will be determined, taking into account other specified factors.

LIQUIDITY RISK MANAGEMENT PROGRAM

If the rules are adopted as proposed, existing liquidity risk management and portfolio monitoring policies and procedures will need to be revised or replaced, and new procedures, data sources and analytical methods may be required.

Classification

Procedures to classify portfolio positions' liquidity would need to consider the specified classification factors. Certain of these may require new or additional data and resources to analyze and use these data. For example, for each position, funds would need to consider: the size of the fund's position relative to average daily trading volume and number of units outstanding; the existence of an active market for the asset, as well as the number, diversity and quality of market participants; and the impact of relationships between assets, such as assets used to "cover" fund obligations under derivative transactions.

Classification procedures should provide for the identification of market, security- and asset-class specific developments that could impact liquidity classifications, and would need to provide for "ongoing" review of liquidity classifications.

Risk Assessment

To assess liquidity risk, funds would be required to consider specified risk factors. Funds would need to consider, among other things: the size, frequency and volatility of historical purchases and redemptions during normal and stressed periods; shareholder ownership concentration; the impact of distribution channels; and the use of borrowings and derivatives (including settlement periods, pricing difficulties and potential obligations with respect to variation margin or collateral calls).

Fund procedures would need to include means of evaluating regulatory, market and fund-specific developments that could impact fund liquidity risk. In light of the proposed definition of liquidity risk—that the fund could not meet redemption requests that are expected under normal conditions or are reasonably foreseeable under stressed conditions without materially affecting the fund's NAV—the proposal contemplates fund consideration of expected or foreseeable redemption requests.

Risk Management

Processes would likely be needed for determining a TDLA minimum in light of the risk factors and for reviewing the TDLA minimum's adequacy at least semi-annually. In regards to such assessments, funds would need to evaluate regulatory, market and fund-specific developments and consider the circumstances under which more frequent or ad hoc review of the TDLA minimum is required. Funds would also need to monitor investments in non-TDLAs.

The 15% prohibition essentially codifies the SEC's existing guidance. If the rule is adopted as proposed, funds should nonetheless confirm that existing procedures would be sufficient for compliance with the 15% prohibition and make any necessary updates.

Program Administrators, Fund Boards

Under the proposal, each fund would have to designate, and its board approve, the adviser or fund officers that are responsible for administering the liquidity risk management program. Portfolio managers would not be permitted to oversee this program on their own.

Administrators would be required annu-

ally to provide the board with a written report reviewing the adequacy and effectiveness of the program's implementation, including the TDLA minimum. To assist with the initial approval of the liquidity risk management program, administrators would be expected to provide summaries of the program's most important features and how it addresses liquidity risk.

Administrators would also be responsible for providing the board with information sufficient to oversee the administrators' performance and, if needed, bringing serious compliance issues to the board's attention. It is unclear at this point whether fund complexes would appoint their compliance staff or other personnel to administer the program. Indeed, the program may require a very specific skill set.

SWING PRICING

If a fund determines to use swing pricing, the policies and procedures described above must be adopted. Before adopting swing pricing policies and procedures, the responsible team will need to ensure that it has planned, coded, tested and installed any necessary system modifications. Once swing pricing policies and procedures are in effect, records will need to be maintained regarding any adjustments to the fund's NAV related to swing pricing.

Fund Flows

For funds that have opted to use swing pricing, the accurate and timely calculation of daily fund flows will be necessary. This calculation will determine whether a fund needs to adjust its NAV on any particular day. It may be appropriate for funds to arrange to receive intraday fund flow data from its transfer agent or other intermediaries in order to accurately estimate daily net flows on a timely basis.

Errors

Swing pricing could potentially introduce a number of new possibilities for errors in the computation of a fund's NAV. Such errors may include:

- The application of an incorrect swing factor to a fund's NAV;
- Adjusting the fund's NAV in the wrong direction;
- Failing to adjust the fund's NAV when the swing threshold has been exceeded.

Error correction procedures may therefore need to be reviewed and updated as needed, including specifying what constitutes an NAV error with respect to swing pricing and the appropriate steps for correcting such an error.

Reports

For funds using swing pricing, consideration should be given to what data and reports may be useful and appropriate in setting, reviewing and adjusting the swing threshold and swing factor. For example, reports on historical fund flows under normal and stressed conditions may be useful in such determinations.

COMPLIANCE DATES

Fund complexes with $1bn or more in net assets would have 18 months following the rule's effective date to come into compliance. Those with less than $1bn in net assets would have 30 months. There is no specified compliance date for the proposed rule's requirements for the swing pricing policies and procedures because the use of swing pricing is optional. In light of the breadth of the proposals and the expectation of relatively heavy industry comment, it may be several years before final rules are effective.

DISCLOSURE, REPORTING

The proposals would require new disclosure and reporting. For example, the Commission has proposed requiring disclosure of the methods funds will use to meet redemption requests, such as the sale of portfolio securities or the use of cash reserves or lines of credit, and whether such methods will be used regularly or only in cases of increased market volatility.

Additionally, the SEC has proposed amendments to proposed Form N-PORT and Form N-CEN to require reporting of certain features of, or items related to, the liquidity risk management program. Finally, swing pricing's impact and use would be included in the fund's financial statements and the notes to the financial statements.

COMPLIANCE NEEDS

The proposals would likely impose substantial new compliance obligations and costs on fund complexes. Liquidity risk management programs would vary based on each series' liquidity risk.

Accordingly, for fund complexes with large numbers of individual funds and diverse strategies, a monolithic liquidity risk management program may not be sufficient. Similarly, where swing pricing is adopted, fund flows and NAV adjustments would be determined at the series level. This would require data and systems to assess whether and when each series' swing threshold is exceeded and to calculate the adjusted NAV taking into account the relevant swing factor.

Although using service providers to comply with the new requirements may be a reasonable option, customization and frequent interaction with portfolio management would likely be necessary. As such, funds should consider carefully whether service provider offerings are sufficient for the funds' compliance needs.

Fund complexes should also consider the appropriate role of fund compliance teams in implementing the Commission's liquidity risk management and swing pricing proposals. The proposals do not specifically task fund chief compliance officers or compliance teams with implementing or reporting on these programs. Rather, fund investment advisers or officers would be designated as program administrators, with the responsibilities being segregated from portfolio management.

Moreover, fund compliance teams may not presently have the resources or expertise to appropriately assess and analyze the classification factors, risk factors, fund flows and other data relevant under the programs. Funds would need to determine compliance and other teams' responsibilities in light of the liquidity risk management and swing pricing programs' complexity. Compliance and risk teams may need to deploy additional resources and personnel in order to meet their responsibilities.

Finally, certain guidance in the SEC's proposal may be particularly noteworthy for compliance team consideration in light of existing practices. For example, with respect to assets segregated to cover fund obligations under derivative transactions, the Commission stated that such assets are "only available for sale to meet redemptions once the related derivatives position is disposed of or unwound." Accordingly, the proposing release seems to imply that the Commission or its staff believes that the liquidity of such assets would be classified using the liquidity of the derivative instruments they are covering, which is not a position that has been published in the past.

> "FUND COMPLIANCE TEAMS MAY NOT PRESENTLY HAVE THE RESOURCES OR EXPERTISE TO APPROPRIATELY ASSESS AND ANALYZE THE CLASSIFICATION FACTORS, RISK FACTORS, FUND FLOWS AND OTHER DATA RELEVANT UNDER THE PROGRAMS."

Additionally, in the context of cross-trades, the Commission noted that "the less liquid an asset is, the more likely it may not satisfy rule 17a-7. Accordingly, for assets that do not trade in active secondary markets, a fund should consider whether 'market quotations are readily available' and a 'current market price' is available and thus whether the asset may be cross-traded in accordance with rule 17a-7."

***Julien Bourgeois, Brendan C. Fox** and **John V. O'Hanlon** are partners in the Financial Services Group of **Dechert LLP** in Washington, D.C. and Boston. **Brenden P. Carroll, Aaron D. Withrow, Brian J. McGrady, Jr.** and **Andrew L. Zutz** are associates in the firm's Washington, D.C. office.*