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Liquidity Risk Management and Swing Pricing: The SEC's New Rules and Rule Amendments

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On October 13, 2016 the Securities and Exchange Commission (SEC or Commission) adopted new rules and rule amendments (Final Rules)[1] designed to promote effective liquidity risk management, reduce the risk that funds would be unable to meet shareholder redemption requests, and to mitigate the dilutive impact of purchase and redemption transactions. Because these changes represent significant revisions to current liquidity risk management requirements and guidance, fund complexes are likely to face substantial and costly changes to their compliance and risk management functions.

Under the Final Rules, registered open-end management investment companies, including exchange-traded funds (ETFs) and exchange-traded managed funds,[2] but excluding money market funds, must establish liquidity risk management programs. The Final Rules also permit, but do not require, registered open-end management investment companies (excluding money market funds and ETFs) to utilize "swing pricing" and include new disclosure and reporting requirements.

Liquidity Risk Management Program: Overview

New Rule 22e-4 under the Investment Company Act of 1940 (1940 Act) requires funds to adopt and implement written liquidity risk management programs, which must include the following elements:

- assessment, management, and periodic review of fund liquidity risk;
- classification and monthly review of fund portfolio investment liquidity; and
- determination and periodic review of a highly liquid investment minimum (HLIM), and adoption and implementation of procedures for responding to a shortfall of the HLIM.

Assessment, Management, and Review of Liquidity Risk

Funds, including so-called In-Kind ETFs,[3] must assess, manage, and review at least annually their liquidity risk, which is the risk that a fund could not meet redemption requests without significantly diluting remaining investors' interests. Funds must consider the following Liquidity Risk Factors, as applicable:[4]

- investment strategy and liquidity of portfolio investments during both normal and reasonably foreseeable stressed conditions, including (i) whether the investment strategy is appropriate for an open-end fund,[5] (ii) the extent to which the strategy involves a relatively concentrated portfolio or large positions in particular issuers, and (iii) the use of borrowings for investment purposes and derivatives;

- short-term and long-term cash flow projections during both normal and reasonably foreseeable stressed conditions;[6]
- holdings of cash and cash equivalents, as well as borrowing arrangements and other funding sources;[7] and
- for ETFs, (i) the relationship between the ETF's portfolio liquidity and the way in which, and the prices and spreads at which, ETF shares trade, including the efficiency of the arbitrage function and the level of active participation by market participants (including authorized participants); and (ii) the effect of the composition of baskets on the overall liquidity of the ETF's portfolio.

Classification of Fund Investments

Funds,[8] other than In-Kind ETFs, must classify the liquidity of their portfolio investments into one of four liquidity categories. In doing so, Funds must take into account relevant market, trading, and investment-specific considerations when making these classifications, and must review their classifications at least monthly in connection with Form N-PORT reporting requirements (or more frequently if changes in relevant market, trading, and investment-specific considerations are reasonably expected to materially affect one or more classifications).[9]

The four liquidity categories are:

(1) **highly liquid investments:** any cash held by a fund and any investment reasonably expected to be convertible into cash in current market conditions in three or fewer business days without the conversion to cash significantly changing the market value of the investment;

(2) **moderately liquid investments:** any investment reasonably expected to be convertible into cash in current market conditions in more than three calendar days, but in seven or fewer calendar days, without the conversion to cash significantly changing the market value of the investment;

(3) **less liquid investments:** any investment reasonably expected to be able to be sold or disposed of in current market conditions in seven or fewer calendar days without the sale or disposition significantly changing the market value of the investment, but where the sale or disposition is reasonably expected to settle in more than seven calendar days; and

(4) **illiquid investments:** any investment not reasonably expected to be sold or disposed of in current market conditions in seven or fewer calendar days without the sale or disposition significantly changing the market value of the investment.

When considering whether a conversion to cash or sale or disposition "significantly chang[es] the market value of the investment," a fund is not required to re-value or re-price the investment for classification purposes, estimate market impact to a precise degree, or incorporate general market movements in liquidity determinations.[10]

Factors in Assessing Relevant Market, Trading, and Investment-Specific Considerations

The Commission identified several factors funds may consider as they assess "relevant market, trading, and investment-specific considerations in classifying its portfolio investments:"[11]

- the existence of an active market for an asset class or investment (including consideration of trading mechanisms and the diversity and quality of market participants), and the exchange-traded nature of an asset class or investment;
- the frequency of trades or quotes, average daily trading volume;
- volatility of trading prices;
- bid-ask spreads;

- standardization and simplicity of an asset class or investment's structure;
- maturity and date of issue for fixed income securities; and
- restrictions on trading and limitations on transfer.

The Adopting Release includes guidance on each of these factors.

Liquidity Classifications Based on Asset Class. Funds generally may classify portfolio investment liquidity according to asset class, but must separately classify investments in certain circumstances. If the fund or its adviser has information about any market, trading, or investment-specific considerations that are reasonably expected to significantly affect the investment's liquidity characteristics as compared to the fund's other portfolio holdings within that asset class, then the fund must separately classify the investment.[12] The Commission clarified that general categories (for example, equities, fixed income) are not sufficient and that procedures for classifying investments' liquidity by asset class should allow for meaningful distinctions between classes and subclasses.[13] Also, the SEC believes that procedures should include provisions (exception processes) for updating default classifications based on market, trading, and investment-specific considerations.[14]

Market Depth. When classifying investments, funds must determine whether trading varying portions of a position in a particular portfolio investment or asset class, in sizes that the fund would reasonably anticipate trading, is reasonably expected to significantly affect the liquidity of the investment or asset class and, if so, this determination must be taken into account when classifying the investment's or asset class' liquidity. Importantly, the Commission noted that if the liquidity classification was adjusted downward as a result of the market depth analysis, the entirety of a fund's position in the investment would be subject to the new classification.[15]

Classification and Derivatives. While funds are not required to identify particular assets segregated or pledged to cover derivatives transactions, a fund must identify the percentage of its highly liquid investments that are segregated to cover, or pledged to satisfy margin requirements in connection with, its derivatives transactions classified as moderately liquid, less liquid, or illiquid. This percentage of highly liquid investments segregated for cover or margin purposes will be disclosed on Form N-PORT and must be excluded when, in the HLIM context, determining whether a fund "primarily holds" assets that are highly liquid investments.

Highly Liquid Investment Minimum

Each fund, other than an In-Kind ETF, that does not primarily hold assets that are highly liquid investments must: (1) determine an HLIM, considering the Liquidity Risk Factors, as applicable;[16] (2) periodically review, no less frequently than annually, the HLIM;[17] and (3) adopt policies and procedures (Shortfall Policies and Procedures) for responding to a "shortfall" of the fund's highly liquid investments below the fund's HLIM (HLIM Shortfall).

A fund's HLIM may not be changed during an HLIM Shortfall without approval from the fund's board of directors, including a majority of directors who are not interested persons of the fund. However, a fund's board is not otherwise required to specifically approve the HLIM. Funds are not prohibited from acquiring assets that are not highly liquid investments during an HLIM Shortfall.

Consideration of Liquidity Risk Factors in Determining the HLIM. The Adopting Release provides guidance for consideration of the Liquidity Risk Factors in determining the HLIM:

- A higher HLIM would generally be appropriate where investment strategies or fund characteristics include (i) less liquid investments; (ii) greater volatility of flows; (iii) the use of borrowings for investment purposes, derivatives, and leveraged strategies; and (iv) the segregation of highly liquid investments for cover or margin purposes.
- A higher HLIM would generally be appropriate, with respect to short-term and long-term cash flow

projections, where there is a concentrated shareholder base, a redemption policy to satisfy redemptions on a next business day basis, a distribution channel that historically attracts investors with more volatile or unpredictable flows, and a lack of substantial visibility into the shareholder base.

- Holdings of cash and cash equivalents, as well as the availability of a line of credit or other funding source, may indicate decreased liquidity risk and may be considered when determining the HLIM.[18]

HLIM Shortfall Policies and Procedures. A fund's Shortfall Policies and Procedures must require the Program Administrator (defined below) to: (1) report to the fund's board, no later than its next regularly scheduled meeting, with a brief explanation of the causes of any HLIM Shortfall, and any actions taken in response; and (2) if the HLIM Shortfall lasts more than seven consecutive calendar days, report to the fund's board within one business day thereafter with an explanation of how the fund plans to restore its HLIM within a reasonable period of time. Any HLIM Shortfall lasting for more than seven consecutive calendar days must also be reported to the Commission on new Form N-LIQUID.

The Commission suggests that Shortfall Policies and Procedures specify some of the actions the fund could consider taking to respond to an HLIM Shortfall, but recognizes the difficulty in specifying in advance all appropriate factors. Also, a fund that regularly encounters HLIM Shortfalls should consider modifying its Shortfall Policies and Procedures.[19]

Funds "Primarily" Holding Assets That Are Highly Liquid Investments. Funds that "primarily" hold assets that are highly liquid investments (PHL Funds) are not subject to the HLIM requirements outlined above. The Commission expects that these funds will address, in their liquidity risk management programs, how they determined their status as PHL Funds, such as by defining "primarily" in this context.[20] Notably, funds may lose their PHL Fund status due to portfolio drift or changes in investment strategies and would, therefore, become subject to HLIM requirements. Importantly, for purposes of determining whether a fund is a PHL Fund, the fund must exclude from its calculations the percentage of fund assets that are highly liquid investments segregated to cover, or pledged to satisfy margin requirements in connection with, derivatives transactions classified as moderately liquid, less liquid, and illiquid investments.

15 Percent Limit on Illiquid Investments

In addition to the floor imposed by the HLIM, funds (including In-Kind ETFs) must maintain a 15 percent ceiling on illiquid investments. Specifically, a fund (including an In-Kind ETF) may not acquire any illiquid investment if, immediately after the acquisition, the fund would have invested more than 15 percent of its net assets in illiquid investments that are assets.[21] With the adoption of this requirement, the Commission withdrew its historical guidance and prior 15 percent guideline on investments in illiquid assets.[22] Importantly, although Rule 22e-4's 15 percent limit on illiquid investments is similar to the prior guideline, the new 15 percent limit incorporates the definition of "illiquid investment" from Rule 22e-4's liquidity classification framework. As such, the new 15 percent limitation incorporates the classification framework's value impact standard and requirement to consider relevant market, trading, and investment-specific factors, as well as market depth.

A fund is not required to divest illiquid investments if the fund's holdings of illiquid investments exceed the 15 percent limit. However, the Commission cautioned that "a fund should not be permitted to exceed the 15 percent limit on illiquid investments for an extended period of time without board oversight."[23] As a result, exceeding the 15 percent limit triggers certain disclosure and board reporting obligations, discussed below.[24]

Procedures for Redemptions in Kind

All funds that engage in, or reserve the right to engage in, redemptions in-kind, and all In-Kind

ETFs, must establish policies and procedures regarding how and when redemptions in-kind will be used. The Commission intends for policies and procedures to address circumstances in which a fund might use in-kind redemptions (that is, at all times or only in stressed conditions), as well as detail the types of events that might trigger such use. In the Adopting Release, the Commission also contemplated in-kind redemption procedures that distinguish among shareholder types and that address how the fund determines which securities it would use in in-kind redemptions and whether the fund will redeem securities in kind in a pro rata or non-pro rata manner.[25]

Board Oversight

A fund's board must now take on new oversight responsibilities, including both standard and event-driven duties, in connection with the requirement that each fund establish a liquidity risk management program. Standard oversight duties include: (1) initially approving the fund's written program; (2) approving the designation of the person or group of persons responsible for administering the program (Program Administrator); and (3) reviewing (at least annually) a written report prepared by the Program Administrator.

The board (including a majority of independent board members) must initially approve a fund's written liquidity risk management program. In doing so, the board may rely on summaries of the program provided by the Program Administrator, legal counsel, or others with knowledge of how the program would be administered. In a departure from the proposal, once a fund implements its liquidity risk management program, the board does not need to approve any material changes thereto. However, the board must still review material changes to the program (as contained in the annual report) in a manner consistent with Rule 38a-1 under the 1940 Act.[26]

The board, including a majority of independent board members, must approve the designation of the fund's liquidity risk management Program Administrator. The Program Administrator function cannot be assigned solely to portfolio managers, but can be assigned to a fund's investment adviser, subadviser, specific fund officer, or group of fund officers. Subject to appropriate oversight by the fund, a fund may also delegate administration of a part of its program to third-party service providers. At least once a year, the board, including a majority of independent board members, must review a written report detailing operation of the program that is provided by the Program Administrator.[27]

Event-Driven Reporting. In addition to the standard approval and oversight responsibilities with regard to liquidity risk management, fund boards must also oversee compliance with the HLIM and illiquid investments limit. The board, including a majority of independent board members, must approve any proposed changes to a fund's HLIM when the fund's portfolio is below the pre-established minimum (that is, during an HLIM Shortfall). In addition, the board must receive a report at the next scheduled board meeting following an HLIM Shortfall. Also, if an HLIM Shortfall continues for more than seven consecutive calendar days, the Program Administrator must report to the board within one business day with an explanation of how the fund plans to restore its minimum within a reasonable period of time.

Regarding illiquid investments, the Program Administrator must report to the board within one business day if a fund's illiquid investments exceed the 15 percent limit on such investments. The Program Administrator must explain the extent and cause(s) of the occurrence and how the fund plans to bring illiquid investments to or below the 15 percent limit "within a reasonable period of time." Also, the board bears additional responsibilities if a fund's illiquid investments remain above the 15 percent limit for more than 30 consecutive days (and each 30-day period thereafter). In that situation, the fund's board, including a majority of independent board members, must assess whether the plan to bring illiquid investments to or below the 15 percent limit continues to be in the fund's best interest.

Guidance on Cross-Trades

The Adopting Release provides guidance on the use of cross-trades, but does not explicitly amend Rule 17a-7 under the 1940 Act.[28] Such guidance indicates that it may be more difficult to determine that the terms of a cross-trade are fair and reasonable when less liquid assets are involved. The Commission also expresses a view that advisers should subject less liquid assets to careful (and potentially heightened) review before cross-trading such assets. In addition, the Commission suggested that a fund's compliance policies and procedures related to Rule 17a-7 should contemplate how the rule's requirements are met with regard to less liquid assets.[29]

Treatment of ETFs

All ETFs. ETFs will be required to adopt a liquidity risk management program and consider two additional factors when assessing their liquidity risk: (i) the relationship between an ETF's liquidity and the manner in which its shares trade; and (ii) the composition of its basket of securities and the effect of that basket on the ETF's liquidity.[30] In addition, as part of new annual reporting obligations on Form N-CEN, an ETF, including an In-Kind ETF, must report "the average percentage value of creation units purchased and redeemed both with in-kind securities and assets and with cash, during the reporting period."[31]

In-Kind ETFs. In-Kind ETFs are exempt from the portfolio liquidity classification and the HLIM requirements but must annually report their classification as In-Kind ETFs on Form N-CEN.[32] Because the In-Kind ETF definition applies to the redemption basket, compliance with this definition requires ongoing monitoring of the amount of cash used to settle each redemption transaction. For example, an ETF that normally redeems in-kind would *not* qualify as an In-Kind ETF if it delivers all cash to a single authorized participant that elects to receive cash.[33]

An In-Kind ETF generally should describe in written policies and procedures, to the extent applicable, how the fund analyzes its ability to redeem in-kind in all market conditions, the circumstances under which it may use a *de minimis* amount of cash to meet a redemption, and what amount of cash would qualify as *de minimis*. An In-Kind ETF should also describe in its written policies and procedures how it will manage and/or approve any portion of a redemption that is paid in cash and document its determination that such a cash amount is *de minimis*.[34]

Swing Pricing

Overview and Scope

The SEC also adopted, by a two-to-one vote, amendments to 1940 Act Rule 22c-1 (Swing Pricing Amendments) that would permit, but not require, funds to mitigate the risk that shareholder purchase and redemption activities could dilute the value of fund shares. By using swing pricing as part of their liquidity risk management programs funds, excluding money market funds and ETFs, would adjust the net asset value (NAV) of a fund's shares to effectively pass on the costs associated with purchases or redemptions to transacting shareholders.

In order to use swing pricing, a fund must establish policies and procedures that, among other things, designate a swing factor and swing threshold. The swing pricing policies and procedures must also (1) specify the process for determining the swing threshold(s) and swing factor(s); and (2) provide for board review of periodic reports prepared by the persons responsible for administering swing pricing.

Swing Threshold

A fund's swing threshold is the level of net purchases into or net redemptions from the fund (expressed as a percentage of the fund's NAV) that triggers the application of swing pricing. A "fund's swing threshold should generally reflect the estimated point at which net purchases or net redemptions would trigger the fund's investment adviser to trade portfolio assets in the near term, to a degree or of a type that may generate material liquidity or transaction costs for the fund."[35] Notably, in-kind purchases and redemptions are excluded from this calculation. A fund may establish multiple escalating swing thresholds, each with a corresponding swing factor.

In determining its swing threshold, a fund must consider, at a minimum, four factors: (1) the size, frequency, and volatility of historical net purchases or net redemptions of fund shares during normal and stressed periods; (2) the fund's investment strategy and the liquidity of the fund's portfolio investments; (3) the fund's holdings of cash and cash equivalents, and borrowing arrangements and other funding sources; and (4) the costs associated with transactions in the markets in which the fund invests.

Under the Swing Pricing Amendments, funds are permitted to establish multiple swing thresholds together with corresponding swing factors associated with each swing threshold. According to the Commission, "permitting such multiple thresholds may allow funds to more precisely target the cost of managing shareholder activities and better mitigate shareholder dilution effects of such transactions."[36]

Swing Factor

The swing factor is the amount by which a fund will adjust its NAV once the swing threshold is crossed, and should reflect the estimated near-term costs associated with purchase and redemption activity that could dilute the interests of existing shareholders. The swing factor is expressed as a percentage of a fund's NAV.

The swing pricing policies and procedures must specify the process for determining the swing factor(s), which process must include a swing factor upper limit (which may not exceed 2 percent of the net asset value per share) and the determination that the swing factor(s) used are reasonable in relationship to certain near-term costs. Specifically, in determining the swing factor(s) and the upper limit, the Swing Pricing Administrator (defined below) may take into account only the near-term costs expected to be incurred by the fund as a result of net purchases or net redemptions that occur on the day the swing factor(s) is used, including spread costs, transaction fees, and charges arising from asset purchases or asset sales resulting from those purchases or redemptions and borrowing-related costs associated with satisfying redemptions.

Swing Pricing in Operation

Under the Swing Pricing Amendments, a breach of a swing threshold requires application of the swing factor equally to all transacting shareholders, regardless of order size.[37] For purposes of determining whether the swing threshold has been breached, a fund using swing pricing would need to monitor shareholder trades or the flow of money into and out of the fund. According to the Commission, funds may need to develop processes, and possibly establish policies and procedures, to obtain sufficient information (from transfer agents) about investor flows and transactions conducted by intermediaries on behalf of investors. Funds will likely rely on investor flow estimates to determine whether the swing threshold has been breached.[38]

Board Considerations

A fund's board, including a majority of the independent board members, must initially approve a fund's swing pricing policies and procedures,[39] as well as the swing threshold(s), swing factor upper limit, and any changes to such threshold(s) or upper limit. The board must also designate the fund's investment adviser or officer(s) responsible for administering the fund's swing pricing policies and procedures (Swing Pricing Administrator).[40] Subsequently, the board must review, at least once a year, a report prepared by the Swing Pricing Administrator.[41]

Disclosure and Reporting Requirements

Form N-1A

To address inconsistent reporting on fund redemption policies and procedures, the Commission adopted amendments to Item 11 of Form N-1A. As a result, funds (all open-end funds, including money market funds and ETFs) must disclose the number (or estimated range) of days when they will pay proceeds to redeeming shareholders.[42] The disclosed pay-out timing must be based on the method of payment, rather than the distribution channel. Funds must also describe the methods they will use to meet redemption requests, including whether such methods will be used regularly or only in stressed market conditions.

Funds using swing pricing must include an explanation in their registration statements regarding the circumstances in which the funds will use swing pricing, the effects of initiating swing pricing, and the fund's swing factor upper limit.

Form N-PORT

On October 13, 2016, the Commission also adopted a series of rules that expand registered investment companies' reporting and disclosure requirements, including a new requirement to file monthly portfolio investment information on new Form N-PORT.[43]

The Final Rules made certain revisions to the Commission's new Form N-PORT:

- ***Liquidity Classification of Portfolio Investments.*** Funds must identify the liquidity classification category of each portfolio investment. Position-level liquidity classifications will be reported monthly on a non-public basis, and aggregate data (percentages of a fund's portfolio investments in each of the four liquidity categories) will be publicly available quarterly on a 60-day delay.
- ***Highly Liquid Investments Used for Cover or Margin Purposes.*** Funds must disclose the percentage of highly liquid investments segregated to cover, or pledged to satisfy margin requirements in connection with, derivatives transactions classified as moderately liquid, less liquid, or illiquid. Like the aggregate liquidity classification data, this data will be publicly available quarterly on a 60-day delay.
- ***Highly Liquid Investment Minimum.*** Funds must disclose their HLIM, any prior HLIMs established during the reporting period, and the number of days in the reporting period during which a fund experienced an HLIM Shortfall. A fund's HLIM will remain non-public.

Additional Reporting

Also in connection with the Modernization Rules, the Commission adopted new Form N-CEN. In the Final Rules, the Commission adopted amendments to Parts C and E of the Commission's new Form N-CEN, requiring funds to report certain information regarding lines of credit, interfund lending and borrowing, and swing pricing, and requiring ETFs to indicate whether they are In-Kind ETFs.

Funds must file non-public reports with the Commission on new Form N-LIQUID within one business day when certain liquidity-related events occur.[44]

Funds should discuss the impact of swing pricing in their financial statements, including the balance sheet and notes to financial statements sections.

Recordkeeping

Funds (including In-Kind ETFs) must comply with the following recordkeeping requirements:

- **Liquidity Risk Management Policies and Procedures**—to be maintained for five years in an easily accessible place.
- **Board Materials**—materials provided in connection with the initial approval of the fund's liquidity risk management program and any materials provided in connection with the board's review of the Program Administrator's annual report, to be maintained for a period of five years, the first two years in an easily accessible place.
- **Highly Liquid Investment Minimum** (if applicable)—written record of the HLIM determination (and any adjustments) to be maintained for a period of not less than five years, the first two years in an easily accessible place.

- **HLIM Shortfall** (if applicable)—materials provided to the board in connection with any HLIM Shortfall to be maintained for a period of at least five years, the first two years in an easily accessible place.
- **Swing Pricing Policies and Procedures** (if applicable)—to be maintained for a period of at least six years in an easily accessible place. Funds must also keep a copy of all supporting documents regarding any adjustments to the fund's NAV as a result of its swing pricing policies and procedures for six years, the first two years in an easily accessible place. In addition, funds must maintain copies of any reports provided to the board by the Swing Pricing Administrator for a period of at least six years, the first two years in an easily accessible place.

Compliance Dates

- **Liquidity Risk Management Program and Form N-LIQUID filing.** For fund complexes[45] with net assets of $1 billion or more as of the end of the most recent fiscal year (larger fund complexes), the compliance date is December 1, 2018. For fund complexes with net assets below $1 billion as of the end of the most recent fiscal year (smaller fund complexes), the compliance date is June 1, 2019.
- **Disclosure and Reporting Requirements.** All initial registration statement filings on Form N-1A and post-effective amendments that are annual updates to effective registration statements on Form N-1A, must comply with the amendments to Form N-1A by June 1, 2017. The compliance date for the Form N-PORT and Form N-CEN filings varies based on the fund's asset size. For larger fund complexes, the compliance date for the Form N-PORT and Form N-CEN amendments is December 1, 2018; for smaller fund complexes, the compliance date is June 1, 2019.[46]
- **Swing Pricing.** Based on operational concerns raised by commenters, the Commission delayed the effective date of the Swing Pricing Amendments until November 19, 2018.

Conclusion

The Final Rules, although scaled back in several ways from what was originally proposed, will require significant changes to fund operations, disclosure, and reporting. Fund complexes that currently dedicate relatively fewer resources to liquidity risk management may be particularly impacted by these changes. All fund complexes, regardless of size and current liquidity risk management practices, should begin reviewing and making necessary adjustments to their operations well ahead of the compliance dates.

The Final Rules will also result in new responsibilities for fund board members, including both standard review and approval requirements as well as event-driven review and approval tasks.

Finally, the Final Rules may have a significant impact on the daily operations of ETFs and will require ETF sponsors to consider operational and structural characteristics relating to the in-kind redemption process.

The Final Rules are part of a five-part plan to improve the regulation of fund portfolio composition as well as fund and adviser operations. The collateral impact of the entire plan remains to be seen as we await finalized rulemakings on funds' use of derivatives, adviser business continuity and transition planning, and stress testing for large funds and advisers.[47]

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NOTES

1 *See Investment Company Liquidity Risk Management Programs*, 81 Fed. Reg. 82,142 (Nov. 18, 2016) (Adopting Release); *See Investment Company Swing Pricing*, 81 Fed. Reg. 82,084 (Nov. 18, 2016) (Swing Pricing Release).

[2] References to ETFs include exchange-traded managed funds.

[3] Rule 22e-4 defines "In-Kind ETFs" as ETFs that meet redemptions through in-kind transfers of securities, positions, and assets other than a *de minimis* amount of cash and publish portfolio holdings daily. As discussed below, In-Kind ETFs are excluded from certain requirements under the Final Rules.

[4] *See* Rule 22e-4(b)(1)(i)(A) – (D).

[5] The Adopting Release notes that "this requirement will likely cause funds to evaluate the suitability of investment strategies that will be permitted under the 15 percent illiquid investment requirement, but still could entail significant liquidity risk" and that funds with significant holdings of securities with extended settlement periods "may face challenges operating as open-end funds." Adopting Release at 82,162.

[6] The Adopting Release provides, in guidance, several sub-considerations relevant to this factor, representing a departure from the Commission's proposal, which would have included these considerations as part of the rule text. Adopting Release at 82,164–66.

[7] Funds should consider: (1) the terms of the credit facility (such as whether the line of credit is committed or uncommitted); (2) the financial health of the institution(s) providing the credit facility; and (3) whether the credit facility would be shared among multiple funds in the fund family. Adopting Release at 82,166.

[8] Unit investment trusts remain excluded from the liquidity risk management program requirements. Adopting Release at 82,221.

[9] Adopting Release at 82,192-93.

[10] Adopting Release at 82,172.

[11] In a departure from the proposal, the Commission decided not to codify these factors in Rule 22e-4, but instead to include them as guidance. Adopting Release at 82,172.

[12] Examples of such considerations include knowledge that (i) a large-capitalization equity security was affected by adverse events impacting the security's issuer; and (ii) certain high-quality corporate bonds' bid-ask spreads were significantly wider or more volatile than those of their peers. Adopting Release at 82,180.

[13] For instance, the Adopting Release notes that: (1) fixed income securities could be distinguished based on issuer type, the market(s) in which the issuer is based, seniority, age, and credit quality; and (2) equity securities could be distinguished based on the market(s) in which the security's issuer is based, market capitalization, and whether the security is common or preferred. Adopting Release at 82,181.

[14] Exception procedures should specify the sources of inputs and particular variables that could impact classification and could also incorporate the liquidity classification factors, discussed below. Adopting Release at 82,181.

[15] Adopting Release at 82,182.

[16] With respect to the fund's investment strategy and liquidity of portfolio investments, and short-term and long-term cash flow projections, the fund is required to consider these factors only as they apply during normal conditions, and during stressed conditions only to the extent they are reasonably foreseeable during the period until the next review of the HLIM. Adopting Release at 82,164.

[17] This requirement was adopted primarily to correlate with the minimum period in which a fund's board would be required to review the Program Administrator's written report (defined and discussed below). The Commission noted that funds may wish to adopt procedures specifying relevant circumstances for more frequent reviews. Adopting Release at 82,205.

[18] Adopting Release at 82,201–02.

[19] Adopting Release at 82,204.

[20] The Adopting Release provides guidance for defining "primarily," stating that "if a fund held less than 50% of its assets in highly liquid investments it would be unlikely to qualify as 'primarily' holding assets that are highly liquid investments." Adopting Release at 82,206 n.726.

[21] Rule 22e-4(b)(1)(iv) specifically refers to investments that are "assets," in order to clarify that the limitation on illiquid investments applies to investments

with positive values, and that the limitation does not permit netting illiquid investments with negative values against illiquid investments with positive values. Adopting Release at 82,207 n.744.

22 Adopting Release at 82,208. The Adopting Release indicates that the Commission is withdrawing existing guidance contained in the following releases regarding the 15 percent limit on illiquid investments, as well as guidance regarding the process for determining the liquidity of an asset: *Revisions of Guidelines to Form N-1A*, Investment Company Act Rel. No. 18612 (Mar. 12, 1992); *Resale of Restricted Securities; Changes to Method of Determining Holding Period of Restricted Securities Under Rules 144 and 145*, Investment Company Act Rel. No. 17452 (Apr. 23, 1990); and *Statement Regarding "Restricted Securities*," Investment Company Act Rel. No. 5847 (Oct. 21, 1969).

23 Adopting Release at 82,209.

24 Adopting Release at 82,197–98.

25 Adopting Release at 82,210.

26 Adopting Release at 82,214.

27 Adopting Release at 82,213.

28 The Adopting Release included a comment that indications of interest and accommodation quotes are not "market quotations" or "market values" for purposes of Rule 17a-7, and that "evaluated prices provided by pricing services are not, by themselves, readily available market quotations." Adopting Release at 82,212 n.801 and accompanying text. We note that the SEC Staff has provided guidance addressing the use of pricing service prices in connection with Rule 17a-7 in certain circumstances.

29 Adopting Release at 82,212. The Commission also suggested that such policies and procedures would address how it is determined that less liquid securities are appropriately used when satisfying Rule 17a-7's requirements, specify the sources of readily available market quotations, provide for assessing the quality of quotations provided by dealers and include certain compliance monitoring provisions.

30 The SEC asserted that if the securities in the basket are not a *pro rata* share of the ETF's portfolio, the overall liquidity profile of the fund could be impacted. Adopting Release at 82,219.

31 Adopting Release at 82,217 n.851.

32 Although In-Kind ETFs are exempt from the liquidity classification requirements, In-Kind ETFs are nevertheless subject to the 15 percent limit on illiquid investments. Adopting Release at 82,215.

33 Adopting Release at 82,217. The Commission is codifying a condition (*i.e.*, full portfolio transparency) of many exemptive orders received by ETF issuers; to comply with the In-Kind ETF definition, this operational obligation will be required of ETF issuers that are not currently subject to this condition in their respective exemptive orders.

34 Adopting Release at 82,217.

35 Swing Pricing Release at 82,096.

36 Swing Pricing Release at 82,098.

37 Swing Pricing Release at 82,094.

38 Swing Pricing Release at 82,100.

39 The board will not be required to approve material changes to the swing pricing policies and procedures. The Commission notes that a fund may wish to establish a swing pricing committee that would be responsible for administering the policies and procedures. Swing Pricing Release at 82,108, 82,110.

40 Additionally, the Swing Pricing Amendments explicitly state that the "administration of swing pricing must be reasonably segregated from portfolio management of the fund and may not include portfolio managers." Also, portfolio managers may not be involved in setting the swing factor. Swing Pricing Release at 82,110.

41 The report must address, at a minimum, the: (i) the Swing Pricing Administrator's review of the adequacy of the swing pricing policies and procedures and the effectiveness of their implementation, including the impact on mitigating dilution; (ii) any material changes to the swing pricing policies and procedures during the review period; and (iii) the Swing Pricing Administrator's review and assessment of the fund's swing threshold(s), swing factor(s), and swing factor upper limit. Swing Pricing Release at 82,108.

42 Funds may also wish to disclose whether payment of redemption proceeds may take longer (up to seven days as provided under the 1940 Act) than the typical number of days disclosed for such payment. Swing Pricing Release at 82,224.

43 For more information on Form N-PORT, *see Investment Company Reporting Modernization*, 81 Fed. Reg. 81,870 (Nov. 18, 2016) (Modernization Rules).

44 Events triggering disclosure include: (i) when more than 15 percent of fund net assets are, or become, illiquid; (ii) when illiquid investments previously exceeded 15 percent of fund net assets, but change so that such investments are less than or equal to 15 percent of fund net assets; and (iii) an HLIM Shortfall lasting more than seven consecutive calendar days. Adopting Release at 82,268–69.

45 The term "fund complex" here refers to funds in the same "group of related investment companies." *See* 1940 Act Rule 0-10(a)(1) and Adopting Release at 82,228 n.997.

46 The compliance date for disclosure and reporting requirements relating to swing pricing is the same as the effective date for the Swing Pricing Amendments. Swing Pricing Release at 82,084.

47 Mary Jo White, Chair, "Statement at Open Meeting: Modernizing and Enhancing Investment Company and Investment Adviser Reporting" (Oct. 13, 2016).