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The SEC's Liquidity Risk Management Proposal

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The Securities and Exchange Commission's (SEC or Commission) recent liquidity risk management proposal represents potentially significant changes to current liquidity risk management practices.[1] Under the Commission's proposal, all registered open-end funds and open-end exchange-traded funds (ETFs), other than money market funds (MMFs), would be required to adopt liquidity risk management programs. Registered open-end funds, other than ETFs and MMFs, also would be permitted to utilize "swing pricing" under certain circumstances. In addition, the proposal would impose new disclosure and reporting requirements.

According to the *Proposing Release*, these proposals generally are intended to reduce the risk that funds would be unable to meet shareholder redemption requests and to minimize the dilutive impact of fund shareholder purchase and redemption transactions. The proposal is the second part of a five-part plan "to enhance the regulation of the risks arising from the portfolio composition and operations of funds and investment advisers."[2] The Commission recently proposed the first part of this five-part plan – a proposal to modernize fund reporting and disclosure.[3] The remaining parts will include measures to "better address risks related to funds' use of derivatives, plan for the transition of client assets, and to stress test funds and advisers."

Liquidity Risk Management Proposal: Program Overview and Scope

Proposed Rule 22e-4 under the Investment Company Act of 1940 (1940 Act) would require each fund[4] to adopt and implement a written liquidity risk management program. Each fund's program would be required to provide for the:

- classification and ongoing review of the liquidity of the fund's portfolio positions;
- assessment and periodic review of the fund's liquidity risk; and
- management of the fund's liquidity risk, including the requirement to determine the "three-day liquid asset minimum."

Classifying the Liquidity of a Fund's Portfolio Positions

Liquidity Classification

The Commission's proposal would require each fund to classify each of its portfolio positions (or portions of a position) into one of six liquidity categories and review each classification on an ongoing basis. The proposed liquidity categories describe the number of days in which the fund's position (or portion thereof) would be convertible to cash at a price that does not materially affect the value of the asset immediately prior to sale. The determination to place an asset in a particular liquidity category would be made "using information obtained after reasonable inquiry" and would be required to take into account, to the extent applicable, nine specified factors, which are described below.

Liquidity Categories. A fund's positions in a portfolio asset (or portions of a position in a particular asset) would be categorized as "convertible to cash" within one business day, two to three business days, four to seven calendar days, eight to fifteen calendar days, 16-30 calendar days or more than 30 calendar days. The phrase "convertible to cash" is defined in the proposal as "the ability to be sold, with the sale settled."[5]

Classification. Under the Commission's proposal, funds will be required to classify each position in a portfolio asset (or portion thereof) using information obtained after reasonable inquiry. A fund could determine to categorize portions of a position in a portfolio asset independently from other portions of the same position.[6] However, the *Proposing Release* notes that categorizing the liquidity of a portfolio position or portions thereof is not to be based solely upon the perceived liquidity of a normal trading lot for the relevant asset. The Commission also notes in the *Proposing Release* that assets should be classified based on "typical"[7] settlement periods for transactions in the relevant jurisdictions and mentions certain types of securities for which transaction settlement periods are normally relatively lengthy.[8]

The *Proposing Release* acknowledges that different funds may classify the liquidity of identical portfolio positions differently, and affirms that the proposed rule does not assign certain asset classes to particular liquidity categories. Although the *Proposing Release* does not explain the "reasonable inquiry" requirement, the Commission notes that an SEC Staff examination of a fund's liquidity classifications would permit examination of "whether the fund considered the required factors" when determining liquidity classifications.[9] Thus, it appears that the Commission anticipates SEC Staff review of a fund's liquidity classification process.

Under the proposal, a position (or portion thereof) would be convertible to cash "at a price that does not materially affect the value of that asset immediately prior to sale" if the price the fund would receive is not reasonably expected to move the price of the asset in the market, independent of other market forces. The *Proposing Release* notes that this requirement is not meant to imply that funds are required to determine the current market price or fair value of an asset "immediately prior to sale."[10]

Factors to Consider in Liquidity Classifications

The proposal would require that funds take the following factors (Liquidity Classification Factors) into account, to the extent applicable, when classifying the liquidity of an asset:

- Existence of an active market for the asset, including whether the asset is listed on an exchange, as well as the number, diversity, and quality of market participants;
- Frequency of trades or quotes for the asset and average daily trading volume of the asset (regardless of whether the asset is a security traded on an exchange);
- Volatility of trading prices for the asset;
- Bid-ask spreads for the asset;
- Whether the asset has a relatively standardized and simple structure;[11]
- For fixed income securities, maturity and date of issue;
- Restrictions on trading of the asset and limitations on transfer of the asset;[12]
- The size of the fund's position in the asset relative to the asset's average daily trading volume and, as applicable, the number of units of the asset outstanding;[13] and
- Relationship of the asset to another portfolio asset.[14]

Funds may use third-party service provider data to inform its consideration of the Liquidity Classification Factors. However, before relying on third-party service providers, funds should "review the quality of the data received from third parties, as well as the particular methodologies used and metrics analyzed by third parties, to determine whether this data would effectively inform or supplement the fund's consideration of the proposed liquidity classification factors."[15]

Ongoing Review of Liquidity Classifications

The proposal would require a fund to review liquidity classifications on an ongoing basis using the Liquidity Classification Factors and to revise such liquidity classifications as appropriate. No specific review procedures are proposed and funds would not be required to monitor for specific developments. However, funds should have policies and procedures intended to identify market developments and security- and asset-class-specific developments that could impact the liquidity classifications.[16]

The *Proposing Release* also notes that the frequency of a fund's ongoing review may be determined based, in part, on the liquidity of its portfolio holdings and the timing of portfolio acquisitions and turnover. In this regard, the *Proposing Release* notes that daily, or even hourly, review of liquidity classifications may be appropriate in some circumstances (such as where portfolio liquidity may depend significantly on current market conditions), while in other circumstances, where portfolio liquidity is generally more stable, less frequent review of liquidity classifications may be appropriate. At a minimum, monthly review of liquidity classifications would be required in order to ensure the accuracy of information reported on proposed Form N-PORT.

Assessing and Periodically Reviewing a Fund's Liquidity Risk

The proposal would require each fund to assess and periodically review its "liquidity risk," which would be defined as "the risk that the fund could not meet requests to redeem shares issued by the fund that are expected under normal conditions, or are reasonably foreseeable under stressed conditions, without materially affecting the fund's net asset value." The *Proposing Release* explains that funds would have to consider both expected redemption requests (such as seasonally-related fund flows or flows related to tax matters) as well as redemption requests that are unexpected but reasonably foreseeable under stressed conditions (such as fund flows related to market conditions, volatility, reputational events, or portfolio management changes).[17]

Under the proposal, funds would be required to consider the following, non-exhaustive list of factors (Liquidity Risk Assessment Factors), as applicable, in assessing the fund's liquidity risk.

- Short-term and long-term cash flow projections, taking into account the following considerations:
  - Size, frequency, and volatility of historical purchases and redemptions of fund shares during normal and stressed periods;[18]
  - The fund's redemption policies;[19]
  - The fund's shareholder ownership concentration;
  - The fund's distribution channels;[20] and
  - The degree of certainty associated with the fund's short-term and long-term cash flow projections;[21]
- Investment strategy and liquidity of portfolio assets;[22]
- Use of borrowings and derivatives for investment purposes;[23] and
- Holdings of cash and cash equivalents, as well as borrowing arrangements and other funding sources.[24]

Under the proposal, funds also would be required to periodically review a fund's liquidity risk in light of the Liquidity Risk Assessment Factors. The Commission did not propose specific review procedures, timing or events that must be considered in a fund's periodic review of liquidity risk. However, the *Proposing Release* notes that a fund may wish to include procedures for evaluating regulatory, market and fund-specific developments.[25]

Managing a Fund's Liquidity Risk

Three-Day Liquid Assets

A central feature of the Commission's liquidity risk management proposal is a set of requirements pertaining to minimum investments in three-day liquid assets (TDLAs). The proposal defines TDLAs as any cash held by a fund and any fund position (or portion thereof) in an asset that the fund believes (taking into account the Liquidity Classification Factors) is convertible to cash within three business days at a price that does not materially affect the value of that asset immediately prior to sale.

Three-Day Liquid Asset Minimum. The proposal would require each fund to determine (in light of the Liquidity Risk Assessment Factors) a three-day liquid asset minimum (TDLA Minimum), which is the percentage of the fund's net assets that must be invested in TDLAs. A written record of this determination must be maintained, the fund's board must approve both the TDLA Minimum and any changes to the TDLA Minimum, and the TDLA Minimum must be publicly disclosed on proposed Form N-PORT.[26]

The proposed TDLA Minimum is intended to be forward-looking and based largely on projected future redemptions. The Commission expects that each fund's TDLA Minimum will be greater than zero and that the TDLA Minimum may vary between funds (even funds that share the same strategy). In addition to cash and cash equivalents, funds may determine to include a variety of assets in the holdings satisfying the TDLA Minimum, including equity, debt, derivatives, and asset-backed securities.[27]

As the "primary goal of a minimum level of liquidity is to ensure that each fund is able to meet redemptions and to do so with minimal dilution of shareholders' interests," the Commission considers cash flow projections as "pivotal to setting an appropriate" TDLA Minimum.[28] The *Proposing Release* also suggests that funds employ stress testing in determining their TDLA Minimum; notes that, where a fund's visibility into its shareholder base is limited or where a fund faces uncertain market conditions, the Commission expects the fund's TDLA Minimum to reflect the related uncertainty in the fund's net redemption projections; and, with respect to borrowings and derivatives, suggests that a fund should consider any "significant fixed obligations to derivatives counterparties (for example, from a total return swap or writing credit default swaps)."[29]

Periodic Review of TDLA Minimum. The Commission views the determination of the TDLA Minimum as a "cornerstone of a fund's liquidity risk management," and proposes to require funds to review the TDLA Minimum's adequacy no less frequently than semi-annually. Specific procedures for reviewing the TDLA Minimum's adequacy are not proposed, but the *Proposing Release* suggests including procedures for evaluating regulatory, market and fund-specific developments, as well as procedures specifying circumstances that trigger ad-hoc review of the TDLA Minimum and governing such ad-hoc reviews.[30]

Limits on Acquiring Non-TDLAs. A fund would be prohibited from acquiring any less liquid asset[31] if, immediately after the acquisition, the fund would have invested less than its TDLA Minimum in TDLAs. A fund would not be required to divest less liquid assets and reinvest in TDLAs in the event that the TDLA Minimum is not satisfied (for example, if the value of a TDLA decreased, causing the fund to have invested less than its TDLA Minimum in TDLAs).[32]

15% Standard Assets

In addition to the floor imposed by the proposed TDLA Minimum, the Commission proposes a 15% ceiling on the amount of relatively illiquid assets a fund may acquire. A fund would be prohibited from acquiring any "15% standard asset" if, immediately after the acquisition, the fund would have invested more than 15% of its net assets in 15% standard assets.[33] This proposal essentially codifies the Commission's current guideline on investments in illiquid assets.

Under the proposal, a 15% standard asset would be any asset that may not be sold or disposed of in the ordinary course of business within seven calendar days at approximately the value ascribed to it by the fund. The *Proposing Release* notes that assets included among 15% standard assets would be consistent with the types of assets currently considered "illiquid" under the Commission's existing guideline.[34] The Commission proposes to withdraw the prior guidance regarding the existing 15% guideline.[35]

Unlike the proposed liquidity classification requirements, for purposes of the definition of 15% standard asset, a fund would not be required to consider the size of its position in the asset. If a fund can sell a standard lot size within seven calendar days at approximately the value ascribed to the asset by the fund, the entire position in the asset would be deemed not to be a 15% standard asset (that is, it would be deemed to be liquid).[36] Additionally, a fund would not be required to consider the number of days associated with receipt of proceeds of sale (that is, a security with a longer settlement period could continue to be deemed to be liquid) or disposition of the asset or any specific factors in determining whether an asset is a 15% standard asset.

Board Responsibilities and Designation of Liquidity Risk Management Program Administrator

Under the proposal, a fund would have to obtain initial approval from its board of directors, including a majority of its independent directors, of the fund's liquidity risk management program, including the TDLA Minimum. Fund directors may satisfy their obligations regarding this initial approval by reviewing summaries of the fund's liquidity risk management program that provide information on the program's most important features and an understanding of how the program addresses the proposal's required liquidity risk assessment and of the determination of the TDLA Minimum. Directors should consider the nature of the fund's liquidity risk exposure and the adequacy of the fund's liquidity risk management program in light of experiences related to fund liquidity. The proposal also would require a fund to obtain approval from its board of directors, including a majority of its independent directors, of any material changes to the liquidity risk management program, including any changes to the TDLA Minimum.

The proposal also would require that a fund's board, including a majority of the independent directors, review no less frequently than annually a written report from the Program Administrator (defined below) that reviews the adequacy and effectiveness of implementation of the fund's liquidity risk management program, including the TDLA Minimum. Where a fund's board is asked to approve a change to the fund's TDLA Minimum, the written report should provide the board with an understanding of how such change was determined to be appropriate.

The proposal also would require that a fund's board, including a majority of the independent directors, approve the entity or person(s) designated by the fund as responsible for administering the fund's liquidity risk management program (Program Administrator). The fund would be required to designate its investment adviser or officers (who may not be solely portfolio managers of the fund) as the Program Administrator.[37] The Program Administrator should generally provide the board with sufficient information to allow the Board to oversee the Program Administrator's administration of the liquidity risk management program. Additionally, in the event of serious compliance issues under the liquidity risk management program, the Program Administrator should consider whether those issues should promptly be brought to the board's attention.[38]

Swing Pricing

Overview and Scope

Under the proposal, funds (excluding MMFs and ETFs) would be permitted, but not required, to use "swing pricing" to mitigate the risk that shareholder purchase and redemption activities could dilute the value of fund shares. For example, when a shareholder tenders fund shares for redemption, a fund may be required to dispose of securities to generate sufficient cash to satisfy the redemption request. The dilution occurs because the costs associated with this trading activity are typically *not* reflected in the price received by the redeeming shareholder.[39] Swing pricing generally refers to a mechanism that would adjust the NAV of a fund's shares to effectively pass on the trading and other costs associated with purchases or redemptions of fund shares to the purchasing or redeeming shareholder. Before a fund could employ swing pricing, it would be required to establish policies and procedures that designate an amount (the swing factor) by which the fund will adjust its NAV if the level of net purchases into or net redemptions from the fund has exceeded a specified percentage of the fund's NAV (the swing threshold). In addition, the policies and procedures would be required to:

- provide for the periodic review (at least annually) of the fund's swing threshold;
- specify how the fund calculates the swing factor in the event the fund's swing threshold is breached; and
- be approved by the fund's board, including a majority of the independent directors.

According to the *Proposing Release*, in recent years, there has been a trend towards the adoption of swing pricing in Europe by major market participants.

Swing Threshold

A fund's swing threshold would be the amount of net purchases into or net redemptions from a fund that triggers the implementation of swing pricing. In-kind purchases and redemptions would be excluded from this calculation. 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."[40] The proposal would require the fund to consider, at a minimum, the following factors:

- The size, frequency and volatility of historical net purchases or net redemptions of fund shares during normal and stressed periods;
- The fund's investment strategy and the liquidity of the fund's portfolio assets;
- The fund's holdings of cash and cash equivalents, as well as borrowing arrangements and other funding sources; and
- The costs associated with transactions in the markets in which the fund invests.[41]

The Commission recognizes that there is a potential for fund shareholders to effectively "game" the fund's use of swing pricing by attempting to time their purchases and redemptions based on the likelihood that a fund would or would not adjust its NAV. However, the Commission does not believe this is a significant concern, as fund complexes would not be required to disclose their swing thresholds or daily net cash flows. Accordingly, the Commission indicated that it is not likely that shareholders would be able to discern when net purchases or net redemptions exceed a fund's swing threshold.[42]

A fund's swing threshold would be determined pursuant to policies and procedures approved by the fund's board. A fund would be required to assess its swing threshold no less frequently than annually, taking into consideration the factors set forth above. Any change to a fund's swing threshold, including as a result of this review, would require approval by the fund's board.

Swing Factor

A fund's swing factor would be defined as the amount by which the fund adjusts its NAV when the fund's net purchases or net redemptions cross the fund's swing threshold. According to the Commission, this amount should reflect the estimated costs associated with purchase and redemption activity that could dilute the value of existing shareholders' interests in the fund.

A fund's swing factor would be required to take into account any near-term costs expected to be incurred as a result of net purchases or net redemptions that occur on the day the swing factor is employed. These costs would include market-related costs and transaction-related fees, including taxes, as well as any borrowing-related costs incurred by the fund in order to meet a redemption request. The proposal contemplates that a fund likely will have to estimate certain of these costs, and therefore the swing factor would represent an estimate of the combined costs associated with purchase or redemption activity. The swing factor would account for near-term costs expected to be incurred by the fund within several days.

A fund's swing factor also would be required to take into account the value of assets purchased or sold by the fund to satisfy shareholder redemption or purchase requests on the day the swing factor is employed, but only if such information would not be reflected in the fund's current NAV computed on that day.

Approaches to Determining the Swing Factor. A fund's swing pricing policies and procedures would be required to specify how a fund will determine the swing factor to be used to adjust the fund's NAV.

The calculation of a fund's swing factor would incorporate an assessment of multiple sources of potential dilution, and so the relevant factors used by a fund in determining its swing factor could vary depending on the facts and circumstances of the particular fund. In light of these considerations, the Commission's proposal provides flexibility for a fund to take a variety of approaches in determining its swing factor. For example, a fund may choose to set an initial "base" swing factor, which could then be adjusted under certain circumstances. Alternatively, a fund may choose to utilize a formula or algorithm that includes certain factors required to be considered in determining the swing factor. In addition, a fund would be allowed to incorporate reasonable estimates for costs that may be difficult to know with precision, to the extent that estimates are deemed necessary or appropriate.

In determining its swing factor, a fund would not be limited by any "ceiling" but would be permitted to voluntarily adopt an upper limit on its swing factor. According to the Commission, such a limit may yield potential benefits to shareholders, including increased transparency regarding the maximum amount that a shareholder could expect the share price to be adjusted as a result of swing pricing.

Application of the Swing Factor. If a fund's swing threshold is breached, the swing factor would be applied equally to *all* purchasing and redeeming shareholders, regardless of the size of their orders or whether such orders would likely create material trading costs for the fund. This could result in certain benefits or costs to shareholders relative to other shareholders in the fund. For instance, a small investor is not likely to create significant liquidity costs for the fund on its own, but if such an investor were to redeem his or her shares on a day that the fund's net redemptions breached the swing threshold, he or she would receive a lower price than would otherwise be the case as a result of the downward NAV adjustment.

In monitoring for breaches of the swing threshold, a fund using swing pricing would need to monitor shareholder trades or flows into and out of the fund. There may be only a limited time in which to make a determination concerning breaches of the swing threshold. To the extent that purchases and redemptions cannot be reasonably ascertained or reasonably estimated until near the time a fund must strike its NAV, the proposal contemplates that such persons may estimate cash flows using "information obtained after reasonable inquiry." In this regard, the Commission suggests that a fund may wish to arrange for interim feeds of fund flows from its transfer agent or distributor in order to reasonably estimate its daily net flows for swing pricing purposes.[43] Effective communication channels between the various entities charged with implementing swing pricing would therefore be an essential component of any fund's swing pricing policies and procedures.

Board Considerations

A fund's board, including a majority of the independent directors, would be required to initially approve the fund's swing pricing policies and procedures (and any material changes thereto). The board would be required to designate the fund's investment adviser or officers responsible for administering these policies and procedures, including responsibility for determining an appropriate swing factor (provided that determination of the swing factor must be reasonably segregated from the portfolio management function). As a fund may choose to adopt swing pricing policies and procedures as part of its liquidity risk management program, the fund's board may wish to provide that the persons (or functional areas) responsible for administering the swing pricing policies and procedures overlap with the Program Administrator. The Commission suggests that a board may wish to consider appointing a committee to administer the fund's swing pricing operations. In addition, the proposal indicates that the board should specify the officers or functional areas that comprise the committee and the regularity of its meetings.

Disclosure and Reporting Requirements

Form N-1A

The SEC proposed amendments to Item 11 of Form N-1A, which would require funds to disclose the number of days in which they will pay redemption requests to redeeming shareholders. In addition, funds would be required to disclose the number of days each distribution channel will satisfy redemption requests should the number of days vary across distribution channels. Moreover, the Commission's proposal would require that funds describe the methods they will use to meet redemption requests (that is, sale of portfolio securities, cash reserves, lines of credit), including whether such methods will be used regularly or only when there is increased market volatility.

Under the proposal, funds would also be required to file, as an exhibit to their registration statements, any agreements entered into for the purpose of accessing lines of credit on behalf of the fund. However, funds would not be required to disclose the fees associated with such arrangements. Funds using swing pricing also would be required to include an explanation in their registration statements regarding the circumstances in which the funds will use swing pricing and the effects of initiating swing pricing.

Form N-PORT

In May 2015, the Commission proposed a series of rules that would expand the reporting and disclosure requirements of registered investment companies, including a new requirement to file monthly portfolio investment information on Form N-PORT. Although Form N-PORT would be filed monthly, only the information reported for the third month of a fund's fiscal quarter would be made publicly available (subject to a 60-day delay). Building on this earlier proposal, the Commission is proposing three amendments to Form N-PORT:

- <u>Liquidity Classification of Portfolio Investments</u>. Funds would be required to identify the liquidity classification category (described above) of each portfolio asset based on the number of days the fund anticipates it would take to convert the asset to cash.
- <u>"15% Standard Asset" to Replace "Illiquid Asset"</u>. Funds would be required to report whether each portfolio asset is a 15% standard asset. According to the proposal, the Commission believes this enhanced disclosure will enable the SEC Staff to better understand the nature of a fund's holdings and track any exposure to liquidity risk.

- "Three-Day Liquid Asset Minimum". Funds would be required to disclose their "three-day liquid asset minimum."

Form N-CEN

In May 2015, the Commission also proposed Form N-CEN, which would require all registered investment companies (including UITs) to report certain census-type information on an annual basis. The Commission is now seeking to amend that previous proposal to require that funds provide additional information regarding the use of lines of credit, interfund lending and borrowing, and swing pricing. With respect to lines of credit, a fund would be required to disclose: (i) whether it has entered into a committed line of credit; (ii) the size of the line of credit (in US dollars); (iii) the name of the institution that is providing the line of credit; and (iv) whether other funds in the fund complex can access the line of credit and the names of those funds. There also would be additional disclosure requirements for any fund that draws on its line of credit during the relevant reporting period.

If a fund engages in interfund lending and/or borrowing during any given reporting period, the fund would be required to disclose the average amount of the loan when the loan was outstanding as well as the period of time the loan was outstanding. The proposal also would require a fund to disclose whether it used swing pricing during the relevant reporting period.

Financial Statement Reporting

With respect to the notes to the financial statements, the SEC is proposing to require a fund to describe the fund's use of swing pricing during the relevant reporting period, including the effects of swing pricing on the fund's financial statements.

Recordkeeping Requirements

Under the proposal, each fund would be required to comply with the following recordkeeping requirements:

- Liquidity Risk Management Policies and Procedures. Funds would be required to maintain these policies and procedures for five years in an easily accessible place.
- Supplemental Materials. Any materials provided to a fund's board in connection with its initial approval of the fund's liquidity risk management program, as well as any material amendments to the program, would have to be maintained for a period of five years, the first two years in an easily accessible place.
- Reports on Adequacy of the Program. Reports on the adequacy of the liquidity risk management program would have to be maintained for a period of at least five years, the first two years in an easily accessible place.
- Three-Day Liquid Asset Minimum. A written record of how a fund determined its TDLA Minimum (and any amendments thereto) would have to be maintained for a period of not less than five years, the first two years in an easily accessible place.
- Swing Pricing Policies and Procedures. A fund's swing pricing policies and procedures would have to be maintained for a period of six years, all in an easily accessible place. A fund also would be required to 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.[44]

Compliance Dates

- Liquidity Risk Management Program. Under the proposal, fund complexes that have net assets of $1 billion or more as of the most recent fiscal year would have 18 months to comply with the new rule. Fund complexes that have net assets below $1 billion would have an additional 12 months (that is, 30 months) to comply with the new rule.
- Swing Pricing. Since a fund's use of swing pricing would be optional, no specific compliance period is proposed.

- Disclosure and Reporting Requirements. All initial registration statement filings and post-effective amendments that are annual updates to effective registration statements would have to comply with the proposed amendments to Form N-1A within six months of the effective date of the proposal's adoption. With respect to the proposed amendments to Form N-PORT, the compliance period would be the same as that for the liquidity risk management program requirements. With respect to the proposed amendments to Form N-CEN, the SEC proposes a compliance date of 18 months for all funds.

Conclusion

Prior to the proposal, the Commission's Staff had engaged with a number of fund complexes to better understand current liquidity risk management practices. Through this outreach, the Commission noted that, "while some funds and their managers have developed comprehensive liquidity risk management programs, others have dedicated significantly fewer resources to managing liquidity risk in a formalized way." If adopted, the SEC's proposals will likely require significant changes to fund operations, disclosure and reporting, particularly for those fund complexes that currently dedicate relatively fewer resources to liquidity risk management.

Comments on the proposal are due on or before January 13, 2016.

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NOTES

1 *See Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release*, 80 Fed. Reg. 62,274 (Oct. 15, 2015) (*Proposing Release*). On the same day, the SEC made public a white paper prepared by the SEC's Division of Economic and Risk Analysis entitled "Liquidity and Flows of U.S. Mutual Funds." *See* Paul Hanouna, Jon Novak, Tim Riley, and Christof Stahel, "Liquidity and Flows of U.S. Mutual Funds," SEC Division of Economic and Risk Analysis (Sept. 2015), available at *https://www.sec.gov/dera/staff-papers/white-papers/liquidity-white-paper-09-2015.pdf*.

2 Mary Jo White, Chair, Statement on Open-End Fund Liquidity Risk Management Programs and Swing Pricing, Securities and Exchange Commission (Sept. 22, 2015).

3 For additional information on the SEC's proposal to modernize fund reporting and disclosure, *see* "US SEC Approves Proposal to Modernize Investment Company Reporting Regime," *Dechert OnPoint* (June 11, 2015), available at *https://www.dechert.com/files/Uploads/Documents/FSG/06-2015-FormattedOnPoint-USSECApprovesProposalModernizeInvestmentCoReportingRegime.pdf*.

4 The term "fund" is defined in the proposed rule as "an open-end management investment company that is registered or required to register under section 8 of the [1940 Act] … and includes a separate series of such an investment company," but does not include MMFs. The *Proposing Release* explains that each series of a fund is itself a fund, and must therefore develop a liquidity risk management program tailored to its own liquidity risk in order to comply with the proposed rule. *See, e.g.*, *Proposing Release* at 62,305 n.262.

5 *See id.* at 62,292 n.169. Because a position falling within the two to three business day liquidity category also could be considered to fall within the four to seven calendar day liquidity category (such as when a position is sold on Thursday and the sale is settled on Monday), funds are instructed to classify the position using the shorter period (*i.e.*, the two to three business day liquidity category) in such cases. *See id.* at 62,295.

6 For example, if 50 percent of a position could be converted to cash within one day, but it would take up to three days to convert the remaining 50 percent of that position to cash, those two portions of the position must be categorized separately.

7 According to the *Proposing Release*, classifications should "not [be] based on the prospect of gaining expedited settlement." *Id.* at 62,295.

8 *Id.* at 62,293 – 62,295. The *Proposing Release* states that certain foreign securities, agency mortgage-backed securities (other than secondary market trades) and US bank loan participations "typically require settlement periods of more than three business days." *Id.* at 62,295-62,296.

9 *See id.* at 62,294. SEC Staff examination of a fund's liquidity classifications may be triggered by, for example, "outlier classifications" reported on Form N-PORT. *See id.*

10 *See id.* at 62,292.

11 The *Proposing Release* notes that the "issue of standardization is particularly significant with respect to the corporate bond market, since corporate issuers commonly have large numbers of bonds outstanding, and trading can be fragmented among that universe of bonds." *Id.* at 62,300.

12 The *Proposing Release* acknowledges prior guidance with respect to factors relevant to the evaluation of liquidity of a Rule 144A security, and states that certain of the proposed Liquidity Classification Factors are consistent with such guidance. The *Proposing Release* also acknowledges that certain assets may be subject to contractual limitations on transfer and that these securities are generally less liquid than securities without such limitation. *Id.* at 62,301 (*citing* Stephen H. Bier, Julien Bourgeois, & Joseph McClain, "Mutual Funds and Loan Investments," *The Investment Lawyer* (Mar. 2015), at 2, available at *https://www.dechert.com/files/Uploads/Documents/FSG/Mutual%20Funds%20and%20Loan%20Investments%20-%20The%20Investment%20Lawyer.pdf*).

13 When considering this factor, the proposal would require funds also to consider the extent to which the timing of disposition of the position could create any market value impact. *See id.*

14 According to the *Proposing Release*, with respect to assets segregated and used to "cover" a fund's obligation under certain types of transactions (as provided in Investment Company Act Release No. 10666 (Apr. 18, 1979) (Release 10666)), such as derivatives transactions, the segregated assets are "frozen" and "unavailable for sale or other disposition" until the related derivatives position is disposed of or unwound. The *Proposing Release* states that "a fund should classify the liquidity of these segregated assets <u>using the liquidity of the derivative instruments they are covering</u>." *Proposing Release* at 62,302 (emphasis added). Classifying segregated assets as having the same liquidity as the derivatives they are covering may represent a significant change in current segregation practice for many funds.

15 *Id.* at 62,297.

16 *Id.* at 62,303.

17 *Id.* at 62,303 – 62,304.

18 The *Proposing Release* suggests certain relevant considerations: the timing of the highest, lowest, most frequent and most volatile purchases and redemptions over certain time frames; purchase and redemption activity in other funds sharing similar investment strategies; and any patterns in the size, frequency, and volatility of historical purchases and redemptions. *Id.* at 62,306.

19 The *Proposing Release* explains that funds should consider obligations for paying redemption proceeds based on fund disclosures and how distribution channels may affect redemption policies. For example, due to the requirements of Rule 15c6-1 under the Securities Exchange Act of 1934 (Exchange Act), open-end funds that are redeemed through broker-dealers must meet redemption requests within three business days. *See id.* at 62,306 – 62,307 and 62,277 n.21 (*citing* Letter from Jack W. Murphy, Associate Director and Chief Counsel, Division of Investment Management, SEC, to Paul Schott Stevens, General Counsel, Investment Company Institute (May 26, 1995)). Additionally, ETFs that typically pay

redemption proceeds in-kind should consider the impact on cash flow projections of policies and expectations with respect to transacting in cash with authorized participants. *Id.* at 62,307.

20 The *Proposing Release* notes that: redemption practices may depend upon distribution channels; the omnibus account structure may limit awareness of the underlying investor base; and certain distribution channels may be correlated with particular purchase and redemption patterns. *Id.*

21 The length of a fund's operating history and experience with market events, observed patterns in purchases and redemptions, and any policies encouraging shareholders to provide advance notice of large redemptions are each noted as potentially relevant to a fund's consideration of the certainty of its cash flow projections. *Id.*

22 Relevant considerations include the fund's: (i) diversification status under the 1940 Act; (ii) status as a regulated investment company under the Internal Revenue Code; (iii) principal investment strategies; and (iv) relative proportion of net assets invested in each of the proposed liquidity categories. *Id.* at 62,308.

23 In addition to the liquidity considerations associated with "covering" borrowings or derivative transactions with liquid assets in accordance with Release 10666, the Proposing Release notes that an assessment of a fund's liquidity risk should include consideration of settlement periods and pricing difficulties associated with complex derivative transactions, as well as any potential obligations with respect to variation margin or collateral calls. *Id.* at 62,309.

24 In assessing the effect of borrowings (particularly lines of credit with commercial banks), the *Proposing Release* notes that funds should consider the terms and amount of the credit facility, whether the line of credit is a committed or standby line of credit, and the financial health of the bank(s) providing the credit facility. If multiple funds in a fund family share a credit facility, the liquidity risk of such funds are related. The terms of interfund lending arrangements and any conditions imposed by the Commission are relevant to assessing the effect of interfund lending programs on fund liquidity risk. Finally, funds should consider statutory and regulatory restrictions on affiliated transactions and leverage. *Id.* at 62,309 – 62,310.

25 *Id.* at 62,311.

26 The written record would enable Commission Staff to determine whether a fund is considering the Liquidity Risk Assessment Factors in determining its TDLA Minimum. *Id.* at 62,313. This contrasts with the proposed approach in the context of liquidity classification determinations. However, in both cases, Commission Staff review is contemplated. *See supra* n.9 and accompanying text.

27 *Proposing Release* at 62,313 – 62,314.

28 *Id.* at 62,312.

29 *Id.* at 62,312 – 62,313.

30 *Id.* at 62,315 – 62,316.

31 A "less liquid asset" is any fund position (or portion thereof) of an asset that is not a TDLA.

32 *Id.* at 62,314 – 62,315.

33 The proposed rule text included in the *Proposing Release* refers to a fund being prohibited from acquiring any 15% standard asset if, immediately after the acquisition, the fund would have invested more than 15% of its <u>total</u> assets in 15% standard assets. *See id.* at 62,385. In all other cases, the *Proposing Release* refers to <u>net</u> assets in this context.

34 *Id.* at 62,317; *see also id.* at 62,284 nn.92-93 and accompanying text.

35 *Id.* at 62,317. The prior guidance proposed to be withdrawn includes guidance contained in the following releases: *Revisions of Guidelines to Form N-1A*, SEC Rel. No. IC-18612 (Mar. 12, 1992); *Resale of Restricted Securities; Changes to Method of Determining Holding Period of Restricted Securities Under Rules 144 and 145*, SEC Rel. No. IC-17452 (Apr. 23, 1990); and *Statement Regarding "Restricted Securities,"* SEC Rel. No. IC-5847 (Oct. 21, 1969).

36 *Proposing Release* at 62,318; *see supra* n.6 and accompanying text.

37 A fund may also designate a sub-adviser as the Program Administrator. *Id.* at 62,325 n.405.

38 *Id.* at 62,324.

[39] Under Rule 22c-1, a fund must price its shares based on the current net asset value (NAV) next calculated after the fund receives the purchase or redemption order. However, as permitted by Rule 2a-4, a fund's NAV is not required to reflect changes in the fund's portfolio holdings and changes in the fund's outstanding shares until the first business day after the fund receives the purchase or redemption order. Swing pricing would allow a fund to direct these costs to the purchasing or redeeming shareholders that triggered the fund's trading activity.

[40] *Proposing Release* at 62,334.

[41] A fund should consider market impact costs and spread costs, as applicable, that the fund typically incurs when it purchases or sells a security. A fund also may wish to consider transaction fees and other charges (*e.g.,* brokerage commissions and custody fees) that the fund typically is required to pay in connection with these transactions. *Id.* at 62,335.

[42] The Commission also notes that the selective disclosure of a fund's swing threshold to certain shareholders could "facilitate fraud." *Id.* at 62,335 and n.483.

[43] *See id.* at 62,341.

[44] Such records generally would include, at a minimum, the fund's unswung NAV, the level of net purchases or net redemptions that the fund encountered (or estimated) that triggered the application of swing pricing, the swing factor that was used to adjust the fund's NAV and relevant data supporting this calculation.