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September 29, 2015

SEC Issues Liquidity Risk Management Proposal for Open-End Funds

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TO:

INTERNAL SALES MANAGERS ROUNDTABLE No. 10-15
SALES AND MARKETING COMMITTEE No. 9-15

RE:

SEC ISSUES LIQUIDITY RISK MANAGEMENT PROPOSAL FOR OPEN-END FUNDS

The Securities and Exchange Commission (“SEC”) recently issued its proposed liquidity risk management rules for mutual funds and open-end ETFs (“funds”). [\[1\]](#) SEC Chair White first discussed this liquidity initiative as part of a broader package of reforms intended to enhance and strengthen the SEC’s regulation of the asset management industry in December. [\[2\]](#)

Broadly speaking, the Proposal’s aim is to promote effective liquidity risk management among funds, and reduce the risk that funds will be unable to meet redemptions, or else will meet redemptions in ways that dilute interests of fund shareholders. At least a couple of findings and trends have motivated the SEC to act. First, SEC staff engaged in industry outreach on this topic, and found variations in the nature of and resources devoted to funds’ liquidity risk management programs. The SEC believes the Proposal will improve overall industry-wide liquidity risk management practices. Second, the SEC notes the growth in the U.S. fund industry in general, and in fixed income and alternative funds employing more complex investment strategies in particular. Further, the SEC notes that over twenty years have passed since it last provided guidance regarding the liquidity of open-end funds. The clear implication is that a renewed focus on liquidity management is timely and appropriate.

The Proposal would:

- Require funds to establish liquidity risk management programs under new Rule 22e-4;
- Permit, but not require, funds (except for money market funds and ETFs) to use

“swing pricing” in pricing their shares, under proposed amendments to Rule 22c-1; and

- Require funds to provide additional disclosures about redemptions, swing pricing (if applicable), and liquidity on Form N-1A, proposed Form N-PORT, and proposed Form N-CEN.

Comments are due within 90 days of the publication of the Proposal in the Federal Register (to date, it has not been published).

I. Summary of the Proposed Liquidity Risk Management Rule

Proposed Rule 22e-4 would require each fund to establish a written liquidity risk management program, tailored to its own liquidity risk. The rule and the required liquidity risk management program would include the following elements:

Classification and ongoing review of the liquidity of portfolio assets: Currently, under SEC guidance an open-end fund may not invest more than 15% of its net assets in “illiquid assets.” [3] Thus, upon acquiring an investment, a fund classifies it as either “liquid” or “illiquid.”

Under the Proposal, each fund would classify and engage in an ongoing review of the relative liquidity of each portfolio position (or portion thereof). The classification and ongoing review would be based on 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 that asset immediately prior to sale. [4] Proposed Rule 22e-4 includes factors that a fund must take into account when classifying and reviewing the liquidity of each portfolio position. [5]

Assessment and periodic review of a fund’s liquidity risk: A fund would be required to assess and periodically review [6] its “liquidity risk,” based on specified factors. [7] Liquidity risk would be defined as the risk that a 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 net asset value (“NAV”).

Management of a fund’s liquidity risk: A fund would be required to manage its liquidity risk, and management would include the following components:

- **Determination and periodic review of a fund’s “three-day liquid asset minimum:”** A fund would determine a minimum percentage of its net assets that it must invest in “three-day liquid assets,” i.e., cash and assets that the fund believes are convertible to cash within three business days at a price that does not materially affect the value of the assets immediately prior to sale. [8] In determining this “cornerstone” of a fund’s liquidity management program, the fund would be required to consider the same factors it must use to assess and periodically review its liquidity risk. [9] The SEC recognizes that three-day liquid asset minimums likely would vary by fund (even for funds within the same strategy), depending on the factors that each fund would consider.

The SEC reasons that this new liquidity requirement is warranted because funds often represent that they will pay redemption proceeds in less than 7 days, [10] and Rule 15c6-1 under the Securities Exchange Act of 1934 establishes a three-day settlement period for security trades effected by a broker or a dealer. Consequently, the SEC believes that funds should position themselves to abide by these more stringent redemption requirements. [11] A fund would review its three-day liquid asset

minimum at least semi-annually, considering the aforementioned factors. [\[12\]](#)

- **Prohibitions on acquisitions of certain assets:** A fund would be prohibited from acquiring “less liquid assets” [\[13\]](#) if immediately after the acquisition the fund would have invested less than its specified minimum in three-day liquid assets. A fund also would be prohibited from acquiring any “15% standard asset” [\[14\]](#) if immediately after the acquisition the fund would have invested more than 15% of its total assets in 15% standard assets.
- **Establishment of policies and procedures for redemptions in kind:** A fund would be required to adopt relevant policies and procedure if it engages in or reserves the right to engage in redemptions in kind.

In its discussion of liquidity risk management, the SEC addresses and provides guidance relating to certain other tools that funds use, including:

- Borrowing arrangements (e.g., lines of credit) and other funding sources;
- Investments in ETFs; [\[15\]](#)
- Suspensions of redemptions; [\[16\]](#) and
- Cross-trading under Rule 17a-7. [\[17\]](#)

Board review and approval: A fund’s board, including a majority of the fund’s independent directors, would be required to approve the fund’s liquidity risk management program, including the fund’s three-day liquid asset minimum, [\[18\]](#) along with any material changes to the program. The board also would be required to review a written report that reviews the program’s adequacy, provided at least annually from the fund’s investment adviser or officer administering the program (the board would approve the designation of the party responsible for administering the program). [\[19\]](#)

Recordkeeping: A fund would be required to maintain: (i) a written copy of the policies and procedures adopted by the fund under the rule; (ii) copies of certain materials provided to the fund board; and (iii) a written record of how the three-day liquid asset minimum, and any adjustments thereto, were determined, including assessment of the specified factors.

II. Swing Pricing Proposal

A. Background

Many types of pooled investment vehicles, including U.S. mutual funds, “mutualize” portfolio transaction costs among fund shareholders. Because of this mutualization, sizable net redemption and purchase activity, and the transaction costs that often follow, have the potential to dilute the value of existing investors’ fund shares, absent some means of apportioning transaction costs to those redeeming or purchasing fund shareholders.

Outside the U.S., some funds use swing pricing to allocate transaction costs to redeeming and purchasing shareholders in certain circumstances. In effect, swing pricing involves a second step in the valuation process, whereby a fund measures daily net purchase or redemption activity and adjusts (or “swings”) the NAV upward (in the case of a net purchase of fund shares, so that transacting shareholders bear the transaction costs from resulting fund purchases of portfolio securities) or downward (in the case of a net redemption of fund shares, so that transacting shareholders bear the transaction costs from resulting fund sales of portfolio securities). A fund has discretion in creating and operating the swing pricing methodology that it uses, which when applied to daily fund flows determines the amount and frequency of its NAV adjustments. [\[20\]](#)

B. Summary of the Proposed Swing Pricing Rule Amendments

The SEC believes that swing pricing “could be a useful tool in mitigating potential dilution of fund shareholders...” [21] The SEC’s proposal would permit, but not require, open-end funds (except for money market funds and ETFs) to engage in swing pricing pursuant to the terms specified in amended Rule 22c-1. The key provisions would include the following:

- **Policies and Procedures:** Under the SEC’s swing pricing proposal, which borrows from the framework outlined by the Association of the Luxembourg Fund Industry, [22] a fund that chooses to use swing pricing would be required to adjust its NAV by a specified swing factor once the level of net purchases into or net redemptions [23] from the fund exceeds a specified swing threshold. The proposed amendments include factors that funds would consider to determine their particular swing thresholds [24] and swing factors, [25] and would require funds to review at least annually their swing thresholds.
- **Board review and approval:** The fund’s board, including a majority of the independent directors, would be required to approve the fund’s swing pricing policies and procedures, along with any material changes to them. [26] The fund’s board also would designate the fund’s investment adviser or officers responsible for administering the swing pricing policies and procedures. [27]
- **Reporting:** For purposes of performance reporting, calculations of NAV-based performance fees, and financial statements, the SEC indicates that funds should use NAVs as adjusted pursuant to their swing pricing policies and procedures. [28]
- **Recordkeeping:** The SEC is proposing amendments to Rule 31a-2 under the Investment Company Act to require a fund that chooses to use swing pricing to create and maintain a record of support for each computation of an adjustment to the NAV of the fund’s shares based on the fund’s swing pricing policies and procedures.

III. Proposed Disclosure Changes

The Proposal features revisions to a number of fund reporting forms, including the following:

Form N-1A: The SEC proposes amending:

- Item 6, to require funds that use swing pricing to explain the circumstances under which they would use swing pricing, as well as its effects. For a fund that invests in other funds (e.g., funds of funds or master-feeder funds), the fund would include a statement that its NAV is calculated based on the NAVs of the funds in which it invests, and that the prospectuses for those funds explain the circumstances under which those funds will use swing pricing and its effects. [29]
- Item 11, to require disclosure (i) of the number of days in which the fund will pay redemption proceeds to redeeming shareholders, and (ii) describing the methods and funding sources the fund uses to meet redemption requests (e.g., through sales of portfolio assets, holdings of cash or cash equivalents, lines of credit, interfund lending, and/or in-kind redemptions), and whether those methods are used on a regular basis or only in stressed market conditions.
- Item 28, to require a fund to file any agreements related to lines of credit for the benefit of the fund as an exhibit to the registration statement (funds need not disclose fee information).

Proposed Form N-PORT: The SEC proposes amending proposed Form N-PORT to:

- Require each fund to identify the liquidity classification of each of its assets. These classifications would use the six categories discussed above, providing the number of days within which the fund could convert the asset to cash. [\[30\]](#)
- Require each fund to disclose its “three-day liquid asset minimum.” This information would allow SEC staff and other interested parties to assess the three-day liquid asset minimums across funds.
- Replace “Illiquid Asset” with “15% standard asset” and require each fund to report for each portfolio asset whether it is a 15% standard asset. [\[31\]](#) This would allow SEC staff and other parties to track the extent that funds are holding 15% standard assets, to discern the nature of those holdings, and track the fund’s exposure to liquidity risk.

Proposed Form N-CEN: The SEC proposes amending proposed Form N-CEN to:

- Require a fund to disclose certain information about lines of credit, interfund lending and borrowing, and swing pricing; [\[32\]](#) and
- Require an ETF to report whether it required that an authorized participant post collateral to the ETF or any of its designated service providers in connection with the purchase or redemption of ETF shares during the reporting period.

IV. Compliance Dates

Proposed compliance dates for the various parts of the Proposal are as follows:

- Larger entities—namely, funds that together with other investment companies in the same “group of related investment companies” have net assets of \$1 billion or more as of the end of the most recent fiscal year—would have a compliance date 18 months after the effective date to comply with proposed Rule 22e-4 (i.e., the new liquidity risk management program rule); smaller entities would have a compliance date 30 months after the effective date.
- The proposed swing pricing amendments would not have a compliance period, because use of swing pricing would be voluntary. Eligible funds wishing to use swing pricing could do so after the effective date. [\[33\]](#)
- All initial registration statements on Form N-1A, and all post-effective amendments that are annual updates to effective registration statements on Form N-1A, filed six months or more after the effective date would have to comply with the proposed amendments to Form N-1A.
- Larger entities’ compliance date for the amendments to Form N-PORT would be 18 months after the effective date; smaller entities’ compliance date would be 30 months after the effective date.
- Funds’ compliance date for the amendments to Form N-CEN would be 18 months after the effective date.

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endnotes

[\[1\]](#) *Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release*, SEC Release

No. IC-31835 (the “Proposal” or the “Release”), available at www.sec.gov/rules/proposed/2015/33-9922.pdf. Unless otherwise indicated, references to “funds,” “mutual funds,” and “open-end funds” do not include money market funds.

[2] *Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry*, Speech by SEC Chair Mary Jo White at The New York Times Dealbook Opportunities for Tomorrow Conference, New York, NY (Dec. 11, 2014), available at www.sec.gov/News/Speech/Detail/Speech/1370543677722#.VloGhTHF884. In addition to this Proposal, the SEC has issued two proposals that would modernize reporting requirements for registered investment companies and registered investment advisers. (See Institute Memorandum No. 29036, dated May 28, 2015, for a summary of these proposed reporting requirements.) In addition to enhanced reporting and liquidity risk management, Chair White also discussed initiatives that would address: (i) funds’ use of derivatives; (ii) transition planning; and (iii) stress testing for large funds and advisers.

[3] Specifically, “illiquid assets” are those that cannot be “sold or disposed of in the ordinary course of business within seven days at approximately the value at which the mutual fund has valued the investment.” See *Revisions of Guidelines to Form N-1A*, SEC Release No. IC-18612, 57 Fed. Reg. 9828 (March 20, 1992); and SEC Division of Investment Management, IM Guidance Update No. 2014-1 at 6 (January 2014) (explaining that the 1992 Guidelines are SEC guidance and remain in effect).

[4] The six categories are: (i) convertible to cash within 1 business day; (ii) convertible to cash within 2-3 business days; (iii) convertible to cash within 4-7 calendar days; (iv) convertible to cash within 8-15 calendar days; (v) convertible to cash within 16-30 calendar days; and (vi) convertible to cash in more than 30 calendar days. A fund could determine that different portions of a single position could be converted to cash within different times—if so, it would categorize distinct portions accordingly. Furthermore, the SEC explains that “the term ‘immediately prior to sale’ is meant to reflect that the fund must determine whether the sales price the fund would receive for the asset is reasonably expected to move the price of the asset in the market, independent of other market forces affecting the asset’s value.” Proposal at 64.

[5] Specifically: (i) 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; (ii) 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); (iii) volatility of trading prices for the asset; (iv) bid-ask spreads for the asset; (v) whether the asset has a relatively standardized and simple structure; (vi) for fixed income securities, maturity and date of issue; (vii) restrictions on trading of the asset and limitations on transfer of the asset; (viii) 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; and (ix) relationship of the asset to another portfolio asset (this could arise in connection with hedging or derivatives transactions). The SEC indicates that this list is not meant to be exhaustive, and not every factor will be relevant in each liquidity determination.

[6] While not explicitly part of the proposed rule, the SEC suggests that funds consider evaluating regulatory, market-wide, and fund-specific developments as part of this periodic review.

[7] Specifically: (i) short-term and long-term cash flow projections, taking into account: (a)

size, frequency, and volatility of historical purchases and redemptions of fund shares during normal and stressed periods; (b) the fund's redemption policies; (c) the fund's shareholder ownership concentration; (d) the fund's distribution channels; and (e) degree of certainty associated with the fund's short-term and long-term cash flow projections; (ii) investment strategy and liquidity of portfolio assets; (iii) use of borrowings and derivatives for investment purposes; and (iv) holdings of cash and cash equivalents, as well as borrowing arrangements and other funding sources. The SEC indicates that this list is not meant to be exhaustive.

[8] The SEC notes that assets eligible for inclusion in a fund's three-day liquid asset minimum holdings could include "a broad variety of securities...[including] equity, debt, derivatives or asset-backed securities..." Proposal at 141.

[9] See *supra*, note 7.

[10] Under Section 22(e) of the Investment Company Act, a fund has up to seven days to pay proceeds to redeeming investors.

[11] Even a fund that customarily pays redemption proceeds in more than 3 days would be expected to determine and abide by its three-day liquid asset minimum.

[12] See *supra*, note 7. These reviews could be more frequent and ad hoc as conditions demand. The SEC expects the determination of the three-day liquid asset minimum to be a "dynamic process, incorporating new or updated information into the fund's assessment of factors, reflecting shareholder-related, fund-management-oriented, or market changes that could affect the fund's ability to meet redemptions." Proposal at 145.

[13] A "less liquid asset" would be defined as any fund position (or portion thereof) that is not a "three-day liquid asset."

[14] A "15% standard asset" would be defined as "an 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." This is nearly identical to the SEC's current "illiquid asset" definition. See *supra*, note 3 and accompanying text. Notably, the new definition states that for this purpose "the fund does not need to consider the size of the fund's position in the asset or the number of days associated with receipt of proceeds of sale or disposition of the asset." This is consistent with interpretive positions that many in the industry have taken in applying the current 15% standard. See Investment Company Institute, *Valuation and Liquidity Issues for Mutual Funds* (Feb. 1997) at 42. However, a fund would have to consider these factors for purposes of the new liquidity classification requirement.

The SEC is proposing to keep this 15% standard along with the new three-day liquid asset minimum because the former "would increase the likelihood that a fund's portfolio is not concentrated in assets whose liquidity is limited and thus may serve as a limit on certain cases of fund illiquidity." Proposal at 154. The SEC also proposes withdrawing its prior guidance related to the current 15% standard.

[15] The SEC recognizes that ETFs are readily tradable, but suggests that funds "assess the liquidity characteristics of an ETF's underlying securities, as well as the characteristics of the ETF shares themselves, in classifying an ETF's liquidity." Proposal at 167.

[16] The SEC requests comment on whether open-end funds, other than money market

funds, should be permitted to suspend redemptions and postpone payment of redemption proceeds under certain circumstances.

[17] The SEC suggests that the less liquid an asset is, the more likely it may not satisfy Rule 17a-7. It also suggests that (i) funds consider whether “market quotations are readily available” and a “current market price” is available for assets that do not trade in active secondary markets (to ensure compliance with the Rule), and (ii) fund advisers consider their duty to seek best execution for each fund, as well as their duty of loyalty to each fund. The SEC requests comment on the Release’s guidance.

[18] The SEC believes that the fund board will provide “independent scrutiny,” necessary because an adviser “might have an incentive to set a low three-day liquid asset minimum in order to permit the fund to invest in additional less liquid assets (because such assets may result in higher total returns for a fund), even though a low minimum may not reflect an appropriate alignment between the fund’s portfolio liquidity profile and the fund’s liquidity needs.” Proposal at 174-175.

[19] Because of concerns about potential conflicts of interest, portfolio managers could not be solely responsible for administering a fund’s liquidity risk management program.

[20] See generally “Swing Pricing,” Association of the Luxembourg Fund Industry (Feb. 2011), available at www.alfi.lu/sites/alfi.lu/files/ALFI_Swing_Pricing.pdf. In establishing a swing pricing methodology, important considerations include: (i) deciding whether to adopt a full or partial swing pricing methodology (Under a partial swing pricing methodology, the fund adjusts its NAV only when it exceeds a predetermined net capital activity threshold (i.e., the swing threshold). Daily activity below the threshold does not result in an NAV adjustment because the attendant transaction costs are smaller. Alternatively, some funds employ a “full swing” methodology whereby any net capital activity will result in NAV adjustments, ranging in size each day depending on the magnitude of the net capital activity.); (ii) if a partial swing pricing methodology is chosen, determining how high to set the swing threshold; and (iii) determining the adjustment factor (i.e., the amount—normally expressed as a percentage—by which the NAV is adjusted).

[21] Proposal at 190.

[22] See *supra*, note 20.

[23] The SEC recognizes that funds would need net fund flow information prior to their deadlines for striking their NAVs, so that they could make any necessary NAV adjustments. Under the proposed amendments, the person determining whether the fund’s level of net purchases or net redemptions has exceeded the fund’s swing threshold may make such determination on the basis of “information obtained after reasonable inquiry.” To this end, the SEC suggests that “a fund may wish to arrange for interim feeds of flows from its transfer agent or distributor in order to reasonably estimate its daily net flows for swing pricing purposes.” Proposal at 239.

[24] The “swing threshold” would be the amount of net purchases or redemptions of fund shares, as expressed as a percentage of the fund’s NAV, that triggers swing pricing. The proposed amendments envision a partial swing pricing methodology (see *supra*, note 20), although they do not stipulate a minimum threshold amount. Factors required to be considered include: (i) the size, frequency, and volatility of historical net purchases or net redemptions of fund shares during normal and stressed periods; (ii) the fund’s investment

strategy and the liquidity of the fund's portfolio assets; (iii) the fund's holdings of cash and cash equivalents, as well as borrowing arrangements and other funding sources; and (iv) the costs associated with transactions in the markets in which the fund invests.

[25] The "swing factor" would be the amount, expressed as a percentage of the fund's NAV and determined pursuant to the swing pricing procedures, by which the fund adjusts its NAV per share when net purchases or redemptions exceed the swing threshold. Factors required to be considered include: (i) any 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 is used (including any market impact costs, spread costs, and transaction fees and charges arising from asset purchases or asset sales); and (ii) the value of assets purchased or sold by the fund as a result of net purchases or net redemptions that occur on the day the swing factor is used, if that information would not be reflected in the current NAV of the fund computed that day. A fund could impose an upper limit on the swing factor, effectively capping the amount by which the fund could adjust its NAV on a given day.

[26] The SEC believes that the decision to implement swing pricing and set its terms could produce conflicts for the fund and the adviser. For instance, an adviser could be reluctant to implement swing pricing because it could increase the volatility of a fund's daily NAV calculations.

[27] Determinations of the swing factor must be reasonably segregated from the fund's portfolio management function.

[28] See *infra*, note 29.

[29] The SEC also proposes amendments to Items 13 (Financial Highlights Information) and 26 (Calculation of Performance Data) that would apply to those funds using swing pricing.

[30] See *supra*, note 4. For a portfolio asset with multiple liquidity classifications, a fund would indicate the dollar amount attributable to each classification.

[31] See *supra*, note 14 and accompanying text.

[32] Specifically, the new requirements would ask each fund to report line of credit information, such as whether it has a committed line of credit, the size of the line of credit, the name of the institution with which the fund has the line of credit, and whether the line of credit is shared among other funds. The item also would require a fund to report whether it engaged in interfund lending or borrowing during the period and, if so, the average amount of the interfund loan when the loan was outstanding and the number of days that the interfund loan was outstanding. Finally, the item would require a fund to disclose whether it engaged in swing pricing during the reporting period.

[33] Those funds wishing to use swing pricing would have to comply with the new prospectus disclosure requirement regarding swing pricing.