

MEMO# 30316

October 14, 2016

SEC Adopts Enhanced Reporting Requirements for Funds and New Liquidity Requirements for Open-End Funds

[30316]

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TO:

ACCOUNTING/TREASURERS MEMBERS No. 30-16
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BROKER/DEALER ADVISORY COMMITTEE No. 35-16
CHIEF RISK OFFICER COMMITTEE No. 30-16
CLOSED-END INVESTMENT COMPANY MEMBERS No. 20-16
COMPLIANCE MEMBERS No. 31-16
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TRANSFER AGENT ADVISORY COMMITTEE No. 49-16
UNIT INVESTMENT TRUST MEMBERS No. 10-16
VARIABLE INSURANCE PRODUCTS ADVISORY COMMITTEE No. 22-16

RE:

SEC ADOPTS ENHANCED REPORTING REQUIREMENTS FOR FUNDS AND NEW LIQUIDITY REQUIREMENTS FOR OPEN-END FUNDS

The SEC adopted new rules and amended existing rules ("reporting rules") intended to enhance transparency and modernize the reporting of information by registered investment

companies (“funds”) on October 13, by a 2-1 vote.[\[1\]](#)

That same day, the SEC unanimously adopted a liquidity risk management program rule and new disclosure requirements for mutual funds and open-end exchange-traded funds (“ETFs”).[\[2\]](#) Additionally, the SEC adopted rule amendments that will permit mutual funds to use swing pricing, along with related disclosure requirements, by a 2-1 vote.[\[3\]](#)

In the coming days, we will provide more detailed summaries of these new requirements; this memorandum provides a brief and timely summary of these important developments.

I. Fund Reporting Rules

The reporting rules require each management investment company (except for money market funds and small business investment companies) and each ETF structured as a unit investment trust to provide additional and more frequent reports of portfolio holdings and other data monthly on new Form N-PORT. The reporting rules also require all funds, except face-amount certificate companies, to file census information annually on new Form N-CEN. The rules, adopted largely as proposed, require the information to be reported in a structured data format, which will allow the SEC and the public to analyze the information more easily and link it to other sources. The rules also amend provisions under Regulation S-X to provide, among other things, enhanced and standardized derivatives disclosure in fund financial statements.

A. Form N-PORT and Regulation S-X Amendments

The reporting rules require funds to provide portfolio-wide and position-level holdings information monthly on Form N-PORT, which will replace Form N-Q, on which funds currently report portfolio holdings for the first and third quarters. Funds must report information on Form N-PORT about the fund and the fund’s portfolio investments as of the close of the preceding month, including:

- general information about the fund;
- assets and liabilities;
- certain portfolio-level metrics, including certain risk metrics;
- information about securities lending counterparties;
- information regarding monthly returns;
- flow information;
- certain information regarding each investment in the portfolio;
- miscellaneous securities (if any);
- explanatory notes (if any); and
- exhibits.

Funds also must report specific information related to derivatives, including the derivative type, a derivative’s counterparty, notional amounts and unrealized appreciation or depreciation, on both Form N-PORT and on fund financial statements. The reporting rules’ adopting release clarifies that funds must report portfolio holdings information on the same trade date basis that they use to compute their net asset value (typically on a Trade Date

+1 basis). As proposed, the form must be filed no later than 30 days after the end of the month and the SEC will make public information on reports for every third month, 60 days after the end of the fund's fiscal quarter. In addition, as recommended by ICI and others, funds will have 60 days after the end of the reporting period for the first and third fiscal quarters to file Regulation S-X-compliant portfolio holdings schedules, rather than 30 days as proposed.

The SEC permitted certain information, as ICI recommended, to remain non-public, including position-level risk metrics, and the reporting of each investment's country of risk and economic exposure. The SEC agreed with ICI and others that the determination of position-level risk metrics can require a number of inputs and assumptions that could cause different funds' position-level risk metrics to vary, even across the same or similar investment products, and could imply a false sense of precision about how various market conditions could affect an investment. Similarly, the SEC concluded that funds evaluate an investment's country of risk and economic exposure subjectively using multiple factors, and that public disclosure could convey a false sense of precision regarding these determinations. The SEC clarified that funds generally may use their own internal methodologies to determine country of risk and economic exposure information and may report them non-publicly on Form N-PORT, provided that those methodologies are consistent with information they report elsewhere.

The SEC considered, but rejected, recommendations by ICI and others that funds not be required to publicly disclose other sensitive information on Form N-PORT, including portfolio-level risk metric information,^[4] information about derivatives financing rates, and the components of non-public indices or baskets underlying derivatives investments. The SEC explained that, because portfolio-level risk metrics are reported at the portfolio level, potential users will not be comparing different risk metrics for the same investment in different funds. Because these risk metrics aggregate each investment's assumptions and projections, they are, in the Commission's view, less likely to imply a false sense of precision. The SEC also adopted, as proposed, the requirement that funds publicly disclose derivatives financing rates, stating that increased disclosure of a swap's terms may improve other funds' ability to negotiate more favorable terms, resulting in more favorable fees and financing terms for funds. The SEC reasoned that, without payment terms for derivative instruments, valuing the risks and rewards of such an investment could be difficult for investors and other potential users. Further, the SEC adopted requirements for funds to publicly disclose the top 50 components of a non-public index or basket underlying a derivative when the derivative's notional exposure is between 1 and 5 percent of the fund's net assets or all components of a non-public index or basket when the derivative's notional exposure exceeds 5 percent of the fund's net assets.

The SEC required that funds provide detailed disclosure of securities lending information, as proposed.^[5] The reporting rules compel funds to disclose detailed securities lending information in either a fund's Statement of Additional Information for open-end funds or a fund's Form N-CSR for closed-end funds, including income and fees from securities lending activities and the fees paid to securities lending agents in the prior year. The SEC believes that these requirements will increase the comparability of securities lending fees between funds, and funds must report this information in a specified table format to enhance this comparability.^[6]

B. Form N-CEN

The reporting rules also require funds to provide census-type information annually on Form

N-CEN, which will replace current Form N-SAR. The form requires funds to disclose general information about the fund and information about the registrant. In addition, each fund must disclose specified information depending on the type of registrant filing the report: (a) management investment company; (b) closed-end management company or small business investment company; (c) exchange-traded fund or exchange-traded managed fund; and/or (d) unit investment trust. As ICI recommended, the SEC extended the time for filing the Form N-CEN from 60 days after the end of the fund's fiscal year to 75 days after the fund's fiscal year.

C. Compliance Dates

The reporting rules will require funds to begin filing reports on the new forms on June 1, 2018, while fund complexes with less than \$1 billion in net assets will be required to begin filing reports on June 1, 2019.

D. Dissenting Vote

Commissioner Piwowar voted against the reporting rules because the rulemaking did not include Rule 30e-3, which he characterized as "the one component of the reporting modernization proposal that promised a reduction in costs for shareholders." As proposed, Rule 30e-3 under the 1940 Act would have allowed funds to provide shareholder reports through websites rather than having to deliver them to shareholders in paper via US mail, provided the funds satisfied certain conditions. To ensure that the Commission adopts Rule 30e-3 before the end of the year, Commissioner Piwowar has committed to neither calling for, nor working on, any non-emergency rulemakings beyond certain identified rulemakings and projects until a final Rule 30e-3 rulemaking is complete.[\[7\]](#)

II. Liquidity Requirements

The SEC's adoption of these liquidity requirements completes the work the SEC first proposed in September 2015.[\[8\]](#) Collectively, the new rules, rule amendments, form amendments, and new forms will:

- Require funds to establish liquidity risk management programs under new Rule 22e-4 (the "liquidity rule");
- Permit, but not require, mutual funds 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, Form N-PORT, Form N-CEN, and Form N-LIQUID.

A. Summary of the Liquidity Rule (Rule 22e-4)

The liquidity rule will require funds to establish written liquidity risk management programs.[\[9\]](#) These programs must include the following elements:

- *Assessment, management, and periodic review of a fund's liquidity risk.* These actions will be based on specified factors, and "liquidity risk" is defined as the risk that a fund could not meet redemption requests without significant dilution of remaining investors' interests in the fund.
- *Classification of the liquidity of portfolio investments.* A fund must classify each

portfolio investment into one of four buckets, based on the number of days in which the fund reasonably expects the investment would be convertible to cash (or simply sold or disposed of, as applicable) in current market conditions without significantly changing the market value of the investment.^[10] Additionally, a fund may classify investments by asset class, unless market, trading, or investment-specific considerations with respect to a particular investment are expected to significantly affect the liquidity characteristics of that investment compared to other portfolio holdings within that asset class.

- *Determination of a highly liquid investment minimum.* A fund must determine a minimum percentage of its net assets to invest in “highly liquid investments,” *i.e.*, cash or investments that are reasonably expected to be converted to cash within three business days without significantly changing the market value of the investment.^[11] The fund must implement policies and procedures for responding to a shortfall below its minimum, which must include board reporting.
- *Limitation on illiquid investments.* A fund will be prohibited from purchasing additional illiquid investments if more than 15 percent of its net assets are illiquid assets.^[12] If a fund breaches the 15 percent limit, the occurrence must be reported to the board, along with an explanation of how the fund plans to bring its illiquid investments back within the limit within a reasonable period of time.
- *Board oversight.* A fund’s board must approve the fund’s liquidity risk management program and the designation of the fund’s adviser or person(s) to administer the program. The board also must review, at least annually, a written report on the adequacy of the program and the effectiveness of its implementation.

B. Swing Pricing Amendments

Outside the US, some funds use swing pricing to allocate transaction costs to redeeming and purchasing shareholders in certain circumstances, as a means of mitigating dilution of the interests of non-transacting shareholders.^[13] Under the new amendments to Rule 22c-1, mutual funds will be permitted, but not required, to use swing pricing. A fund that opts to use swing pricing would adjust its NAV per share by a specified amount (the swing factor) once the level of net purchases into or net redemptions exceeds a specified percentage of the fund’s NAV (the swing threshold). A fund’s swing pricing policies and procedures must specify how it would determine its swing factor(s)^[14] and swing threshold(s) (taking into account certain considerations).

The fund’s board must approve the swing pricing policies and procedures, along with the swing factor upper limit, swing pricing threshold, and any changes thereto. The board must periodically review a written report that will, among other things, review the adequacy of the fund’s swing pricing policies and procedures and the effectiveness of their implementation.

C. Liquidity-Related Disclosure Requirements

Funds must provide liquidity-related information on the following forms:

- *Form N-1A:* A fund must describe its procedures for redeeming fund shares, the number of days in which the fund typically expects to pay redemption proceeds, and its methods for meeting redemption requests. Amendments to Form N-1A and Regulation S-X also address financial statement and performance reporting related to

swing pricing, and require funds that use swing pricing to provide an explanation of its use in the registration statement.

- *Form N-PORT*: A fund must report the aggregated percentage of its portfolio representing each of the four classification categories.[\[15\]](#) A fund also must report to the SEC, on a confidential basis, position-level liquidity classification information and information regarding the fund's highly liquid investment minimum.
- *Form N-CEN*: A fund must disclose information regarding the use of lines of credit and interfund borrowing and lending. An ETF will report if it is an "In-Kind ETF." A fund using swing pricing will report information about its use, including its swing factor upper limit.
- *Form N-LIQUID*: This new form[\[16\]](#) will require a fund to confidentially notify the SEC when the fund's level of illiquid assets exceeds 15 percent of its net assets, or when its highly liquid investments fall below its minimum for more than a brief period of time.

D. Liquidity Compliance Dates

Compliance dates for the various requirements are as follows:

- Most funds must comply with the liquidity rule by December 1, 2018, while fund complexes with less than a \$1 billion in net assets must do so by June 1, 2019.
- The swing pricing amendments will become effective 24 months after publication in the Federal Register.
- The compliance dates for the form amendments differ by form.

III. ICI Activity in Connection with New Fund Requirements

These new enhanced fund reporting and liquidity requirements will bring about significant changes for the fund industry. To assist members in analyzing and implementing them, ICI will:

- Host a one-day conference on November 17 in Boston, at which we will cover these new requirements in depth. We will be joined by senior SEC staff. Information about this event and registration can be found at www.ici.org/events/upcoming/conf_16_sec_rules.
- Devote panels to these subjects at ICI's Securities Law Developments Conference in Arlington, VA (outside Washington, D.C.) on December 6. We will be joined by senior SEC staff. Information about this event and registration can be found at www.ici.org/events/upcoming/conf_16_seclaw.

ICI also will conduct robust discussions of these topics at future ICI Committee meetings, including the following during the next few weeks:

- Broker-Dealer Advisory Committee (October 18)
- Transfer Agent Advisory Committee (November 2)
- SEC Rules Committee Meeting (November 3)
- Municipal Securities Advisory Committee (November 10)

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endnotes

[1] *Investment Company Reporting Modernization*, SEC Release No. IC-32314 (Oct. 13, 2016), available at www.sec.gov/rules/final/2016/33-10231.pdf.

[2] *Investment Company Liquidity Risk Management Programs*, SEC Release No. IC-32315 (Oct. 13, 2016), available at www.sec.gov/rules/final/2016/33-10233.pdf. Unless otherwise indicated, in the discussion related to the new liquidity requirements, references to “funds,” “mutual funds,” and “open-end funds” do not include money market funds (and references to “funds” do not include closed-end funds).

[3] *Investment Company Swing Pricing*, SEC Release No. IC-32316 (Oct. 13, 2016), available at www.sec.gov/rules/final/2016/33-10234.pdf.

[4] In response to comments of ICI and others, however, the Commission did make many helpful modifications to the requirements for risk metrics reporting, including requiring the reporting of risk metrics at fewer key rates and increasing the requirement to report risk metrics to funds whose debt investments and related derivatives’ notional values exceed 25 percent of a fund’s net assets, rather than 20 percent.

[5] The SEC did not accept ICI and other commentators’ recommendations that certain securities lending information either not be required to be reported or remain non-public.

[6] The SEC also rejected ICI’s recommendation that funds only disclose the top five securities lending counterparties (borrowers). In adopting the requirement that funds list all securities lending counterparties, the SEC highlighted its goal of increasing transparency and stated that, despite some commenters’ assertions that securities lending counterparties (borrowers) do not want to be identified and identification could impact securities lending activities negatively, the SEC found no evidence that public disclosure would cause such harm.

[7] Commissioner Piwowar identified the following rulemakings and projects as ones that already are scheduled for consideration: a Consolidated Audit Trail release, final rules regarding capital and margin requirements for security-based swap dealers, two yet-to-be-named proposals that the SEC is considering, weekly enforcement meetings, an Equity Market Structure Advisory Committee meeting, a FinTech roundtable, and a Regulation S-K study required by section 72003 of the FAST Act.

[8] *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, available at www.sec.gov/rules/proposed/2015/33-9922.pdf. Institute Memorandum No. 29367, dated September 28, 2015, provides a detailed summary of the proposal. We provide links to and summaries of ICI's numerous comment letters on the proposal in Institute Memorandum No. [29643](#), dated January 14, 2016, and Institute Memorandum No. [29920](#), dated May 18, 2016.

[\[9\]](#) The rule would exempt ETFs that qualify as “In-Kind ETFs” from certain requirements (most notably, the asset classification and highly liquid investment minimum requirements). Additionally, UITs are generally excluded from the rule’s requirements. However, on or before the date of initial deposit of portfolio securities into a registered UIT, the UIT’s principal underwriter or depositor must determine that the portion of the illiquid investments that the UIT holds or will hold at the date of deposit that are assets is consistent with the redeemable nature of the securities it issues, and must maintain a record of that determination.

[\[10\]](#) The four categories are: “highly liquid investments” (investments convertible into cash in three business days or less), “moderately liquid investments” (investments convertible into cash in more than three calendar days but in seven calendar days or less), “less liquid investments” (investments able to be sold or disposed of in seven calendar days or less), and “illiquid investments” (see *infra*, note 12, for definition). Determinations must take into account the market depth of the investment or asset class.

[\[11\]](#) “In-Kind ETFs” and funds primarily holding highly liquid assets are exempt from this requirement.

[\[12\]](#) An “illiquid investment” is an investment that the fund reasonably expects cannot be sold in current market conditions in seven calendar days or less without significantly changing the market value of the investment. The determination will follow the same process as the other liquidity classifications, including at least monthly reviews.

[\[13\]](#) 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 investments) 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 investments).

[\[14\]](#) The fund must establish and disclose an upper limit on the swing factor, which may not exceed two percent of net asset value per share.

[\[15\]](#) See *supra*, note 10.

[\[16\]](#) The proposal did not include this form or filing requirement.