October 5, 2015

SEC Proposes Rules to Require Liquidity Risk Management Programs for Funds and to Permit Swing Pricing of Fund Shares

In a September 22, 2015 Release (the "Release"), the SEC published the following proposals:

- ***Proposed Rule 22e-4, which would require open-end funds (including ETFs but not money market funds) to adopt liquidity risk management programs.*** These programs would require review and management of a fund's liquidity risks, including classifying each asset into a specific liquidity category, and maintaining a portion of the fund's holdings in assets that a fund believes could be converted to cash within three business days.
- ***Revised Rule 22c-1, which would permit, but not require, an open-end fund (other than an ETF or a money market fund) to implement "swing pricing."*** Swing pricing would allow a fund to adjust its NAV to pass on to purchasing or redeeming shareholders the costs arising from their trade activity.
- ***New disclosure and data reporting requirements, which would disclose information about a fund's liquidity risk and how that liquidity risk is managed.*** These requirements would be implemented through amendments to Form N-1A and through additional reporting requirements on proposed Forms N-PORT and N-CEN.

The Release describes these proposals as a "multi-layered set of reforms designed to promote effective liquidity risk management . . . and thereby reduce the risk that funds will not be able to meet redemption obligations and mitigate potential dilution of the interests of fund shareholders." Together they mark significant advances in two key components of the SEC's regulatory agenda announced by Chair White in late 2014: enhancing controls on risks related to portfolio management and enhancing data reporting. Each proposal is described in detail below.

Proposed Liquidity Risk Management Programs

Proposed Rule 22e-4 would require open-end funds, including ETFs and exchange-traded managed funds but excluding money market funds, to establish written liquidity risk management programs. "Liquidity risk" would be defined as "the risk that a 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." A fund's liquidity risk management program would be required to include (i) the classification of the liquidity of each of the fund's assets, (ii) the assessment and periodic review of the fund's liquidity risk, and (iii) management of the fund's liquidity risk, including by maintaining a minimum percentage of the fund's net assets in holdings that could be converted to cash within three business days. These components are discussed below.

- Classification of the Liquidity of Each Asset. Under proposed Rule 22e-4, a fund must classify each of the fund's assets into one of six categories, each corresponding to the amount of time that is expected to be needed to convert the asset to cash "at a price that does not materially affect the value of that asset immediately prior to sale": (a) 1 business day, (b) 2-3 business days, (c) 4-7 calendar days, (d) 8-15 calendar days, (e) 16-30 calendar days, and (f) more than 30 calendar days. The proposed rule includes a non-exhaustive list of factors that a fund would be required to consider when determining the appropriate classification of a particular asset,[1] and acknowledges that

[1] The factors are (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

some holdings may need to be classified in more than one category. In addition, a fund would be required to review the liquidity classification of each of its assets on an ongoing basis and, when appropriate, would be required to revise its liquidity classifications.

Notes: *The proposed categorization approach "would require a fund to assess the liquidity of its entire position in a portfolio asset, or each portion of that position, as opposed to the liquidity of the normal trading lot" for the asset. The Release notes that a fund could, for example, classify 50% of a particular position in one category and the other 50% of the position in a separate category if the fund concludes, based on the factors that are required to be considered in making liquidity classifications, that it would take the fund longer to convert the entire position to cash than it would take to convert only a portion of the position to cash.*

The Release notes that a fund may be able to obtain data and analyses from third-party service providers to "inform or supplement" its consideration of the classification factors, but highlights the importance of appropriate due diligence as to the quality and effectiveness of such data and analyses.

The Release notes that the liquidity category assigned to cash and other liquid assets held in respect of a derivatives position, whether earmarked or segregated to avoid senior security concerns or pledged as initial or variation margin, should be based on the extent to which they can be made available to satisfy redemptions. Thus Rule 22e-4 would require a fund look to the liquidity of the derivative instrument in determining how the liquidity of the related cash or other liquid assets should be classified.

- <u>Liquidity Risk Assessment</u>. Proposed Rule 22e-4 would require a fund to assess its liquidity risk based on the following non-exhaustive list of factors:

  - 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, the fund's redemption policies, the fund's shareholder ownership concentration, the fund's distribution channels, and the degree of certainty associated with the fund's short-term and long-term cash flow projections;
  - The fund's investment strategy and liquidity of portfolio assets;
  - Use of borrowings and derivatives for investment purposes; and
  - Holdings of cash and cash equivalents, as well as borrowing arrangements and other funding sources.

  Proposed Rule 22e-4 would require a fund to review its liquidity risk assessment periodically (up to daily, or even hourly, depending on facts and circumstances), but does not prescribe a specific time period for periodic reviews or articulate the types of developments that should be considered.

  Note: *The Release contemplates that a fund may adopt "individualized" procedures to review the fund's liquidity risk and suggests that such procedures may have triggers related to regulatory, market-wide, fund-specific, and asset-specific developments that affect the factors listed above.*

- <u>Liquidity Risk Management</u>. To manage a fund's liquidity risk, proposed Rule 22e-4 would require a fund (i) to determine, at least semi-annually, the fund's "three-day liquid asset minimum"; (ii) to limit acquisitions of any "less liquid asset" or any "15% standard asset" under certain circumstances; and (iii) to establish policies and

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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 (analysis of position size should consider the extent to which the timing of disposing of the position could create any market value impact); and (ix) any relationship of the asset to another portfolio asset. The Release discusses each factor and provides the SEC's view on the relevant considerations behind each factor.

procedures covering redemptions in kind. These requirements are described below:

- “Three-day liquid asset” means cash held by a fund and any asset that the fund believes could be converted into cash within three business days at a price that does not materially affect the value of that asset immediately prior to sale. A fund’s “three-day liquid asset minimum” means the percentage of the fund’s net assets to be invested in three-day liquid assets.[2] To determine its three-day liquid asset minimum, proposed Rule 22e-4 would require a fund to consider the same factors (listed above under “Liquidity Risk Assessment”) that a fund would be required to consider in assessing liquidity risk.

  Notes: *According to the Release, as part of its liquidity risk management, a fund would be required “to determine a three-day liquid asset minimum to increase the likelihood that the fund will hold adequate liquid assets to meet redemption requests without materially affecting the fund’s NAV.” The Release described cash flow projections as pivotal to setting an appropriate three-day liquid asset minimum, and notes that funds that have less certainty regarding cash flow projections, less overall portfolio liquidity, or a leverage strategy may need to establish higher three-day liquid asset minimums.*

  For funds that hold significant quantities of assets that have previously been determined to be liquid (e.g., bank loans), new Rule 22e-4 may require strategy or portfolio management changes in order to implement a reasonable three-day liquid asset minimum. The Release provides an example of a bank loan fund with 2% of its assets invested in three-day liquid assets <u>and</u> a committed credit line and asserts that, based on review of the required factors (assumed, for purposes of the example, to demonstrate volatile cash flows during periods of market stress and reduced performance, with prior experience of a 5% redemption of net assets during a one-week period), the fund “would have a difficult time concluding that its existing three-day liquid asset holdings would be an adequate minimum.”

- A “less liquid asset” is any fund asset that is not a three-day liquid asset. As part of its liquidity risk management, proposed Rule 22e-4 would prohibit a fund from acquiring any less liquid asset if, immediately after the acquisition, the fund would have invested less than its three-day liquid asset minimum in three-day liquid assets. A “15% standard asset” is any fund 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 (consistent with the SEC’s longstanding guidance). Rule 22e-4 would codify this guidance by prohibiting a fund from acquiring any 15% standard asset if, immediately after the acquisition, the fund would have invested more than 15% of its total assets in 15% standard assets.

  Note: *The Release states that a fund does not need to consider market, trading, or asset-specific factors (e.g., trading volume, size of the fund’s position, time to settle) in determining whether an asset is a 15% standard asset, but may base its determination solely on the fund’s ability to sell a standard size lot.*

- As part of its liquidity risk management, proposed Rule 22e-4 would require a fund to establish policies and procedures regarding redemptions in kind, to the extent that the fund engages in or reserves the right to engage in redemptions in kind.

  Notes: *While many complexes that reserve the right to make redemptions in kind have procedures covering redemptions in kind to affiliates of a fund such as 5% shareholders (in line with the <u>Signature Financial</u> no-*

[2] The choice of a three-day time period seems linked to the broker-dealer requirements for settlement of redemption proceeds in accordance with Rule 15c6-1 under the Securities Exchange Act of 1934, which is cited in the Release’s general discussion of liquidity concerns for mutual funds.

action letter), regardless of the ultimate outcome of this portion of proposed Rule 22e-4, complexes should consider whether those procedures should be broadened to cover redemptions in kind to non-affiliates.[3]

The Release requests comment on whether the SEC should propose a rule similar to Rule 22e-3 that would permit open-end funds other than money market funds to suspend redemptions and postpone payment of redemption proceeds in an orderly liquidation of the fund under certain circumstances.

Proposed Rule 22e-4 would require initial approval of a fund's liquidity risk management program (including the fund's three-day liquid asset minimum), as well as approval of any material change to the program, by the fund's board.[4] In addition, a fund's board must approve the designation of the fund's investment adviser or officers (which may not be solely portfolio managers of the fund) as responsible for administering the fund's liquidity risk management program. The fund's board would be required to review at least annually a written report prepared by the fund's investment adviser or officers administering the liquidity risk management program that describes the adequacy of the program and the effectiveness of the program's implementation. Proposed Rule 22e-4 would also impose recordkeeping requirements relating to the liquidity risk management program.

Note: *We note that several elements of proposed Rule 22e-4 echo recent requests made and deficiencies cited during SEC examinations of investment advisers to fixed income and alternative investment funds after the SEC identified this as an area of focus in its 2014 Examination Priorities. Following a January 2014 IM Guidance Update on liquidity of fixed income funds, the SEC examination staff began requesting information about policies relating to liquidity measurement and use of "buffer assets" to help meet redemptions. Proposed Rule 22e-4 would go beyond that initiative to require liquidity risk management in all asset classes. Furthermore, both the language in the Release and the tenor of SEC requests during examinations support the conclusion that the SEC staff views robust liquidity risk management as a necessary corollary for open-end funds registered under the 1940 Act. Hence, even if Rule 22e-4 is ultimately not adopted, investment advisers and fund officers would be well served to review the elements in the proposed rule when considering how to meet their obligations with respect to operating open-end funds that may potentially hold illiquid assets.*

Proposed Optional Swing Pricing

The Release also would amend Rule 22c-1 (the forward-pricing rule) to permit adjustments to the NAV of an open-end fund (other than an ETF or a money market fund) during times of increased purchase or redemption activity ("swing pricing"). According to the Release, when a fund trades portfolio holdings due to shareholder purchases or redemptions requests, the costs associated with this trading activity can dilute the value of existing shareholders' interests in the fund. Swing pricing would allow a fund to adjust its NAV to pass on to purchasing or redeeming shareholders more of the costs stemming from their purchases and redemptions.

Note: *As noted in the Release, an increasing number of non-U.S. funds, including European UCITS funds, currently use swing pricing, and several commentators to the Financial Stability Oversight Council's 2014 Notice seeking public comment on asset management products recommended swing pricing as a potential mechanism for mitigating dilution caused by shareholders' purchase and redemption activity.*

As proposed, Rule 22c-1 would permit, but not require, a fund to use swing pricing under certain circumstances. Before a fund could use swing pricing, the fund would be required to have swing pricing policies and procedures providing that the fund will adjust its NAV by an amount (the "swing factor") if the level of the fund's net purchases or net redemptions exceed a specified percentage of the fund's NAV (the "swing threshold").[5] The Release states

[3]In some cases, a fund's organizational documents may set forth specific requirements (e.g., board approval or findings) for redemptions in kind, which should be incorporated into such procedures.
[4]The Release clarifies that a fund may increase its minimum holdings in three-day liquid assets without waiting for formal board approval to increase the three-day liquid asset minimum.
[5]In making a determination as to the swing threshold, a fund would be required to consider (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

that the swing threshold should be designed to approximate the point at which a fund would be required "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" (emphasis added). A fund would not be required to disclose publicly its swing threshold due to concerns that shareholders may attempt to time their transactions based on this information.

While the swing factor could vary depending on the facts and circumstances, the procedures for determining the swing factor would be required to consider estimates of near-term costs that are expected to be incurred as a result of purchase or sale activity occurring on the day the swing factor is used, including market impact costs, spread costs, transaction fees, and borrowing-related costs necessary to satisfy redemption requests. The Release does not propose a formula for the calculation of a swing factor.

Proposed Rule 22c-1 would require initial board approval (including by a majority of independent directors/trustees) of a fund's swing pricing policies and procedures (including the fund's swing threshold, and any swing factor upper limit specified under the fund's swing pricing policies and procedures), as well as board approval of any material changes to the policies and procedures (including any decision to suspend or terminate a fund's swing pricing policies and procedures).

Notes: *The Release notes that a board might approve a fund's swing pricing policies and procedures "under the premise that such policies and procedures would not unduly disadvantage any particular group of shareholders, and that any disadvantages that could affect certain shareholders would generally be outweighed by the benefits to the fund as a whole."*

The Release also provides proposed guidance on certain operational considerations relating to swing pricing, such as timing for the determination of NAV, performance reporting, calculation of NAV-based performance fees, fund merger considerations, the application of swing pricing to master-feeder funds, and financial statement disclosures.

Disclosure Changes and Reporting Obligations

The Release would establish a number of disclosure and reporting obligations intended to increase the amount and quality of information available to investors and the SEC regarding a fund's redemption practices, its management of liquidity risks and how liquidity risk management can affect redemptions. Proposed amendments to Form N-1A would require a fund (i) to disclose the number of days within which the fund will pay redemption proceeds to shareholders (if the number of days in which the fund will pay redemption proceeds differs by distribution channel, the fund also must disclose the number of days for each distribution channel); (ii) to disclose the methods that the fund uses to satisfy redemption requests (*e.g.*, cash equivalents maintained by the fund, proceeds of the sale of portfolio holdings, or borrowings by the fund) and whether those disclosed methods are used regularly or only in stressed market conditions; and (iii) to file with the SEC any credit agreements to which the fund is a party as exhibits to the fund's registration statement. A fund that opts to utilize swing pricing would be required to explain in its Form N-1A the circumstances in which swing pricing would be required to be used and the effects of swing pricing. Finally, in the financial highlights and performance data sections of Form N-1A, a fund would be required to adjust the presentations to show the effects, if any, of its use of swing pricing (the Release would amend Regulation S-X to require analogous changes that would require a fund to show in its financial statements how the fund's NAV has been affected by swing pricing).

The Release also would add requirements to the information that a fund would need to report on proposed Forms N-PORT and N-CEN. A fund would be required to disclose on Form N-PORT the classifications of each portfolio holding within the categories established pursuant to proposed Rule 22e-4, as well as the fund's three-day liquid asset minimum. Finally, the Release would amend proposed Form N-CEN to require the reporting of census-type information relating to the use of lines of credit, interfund lending and swing pricing. In connection with these changes, the Release reopened the comment period for the rule proposals relating to Forms N-PORT and N-CEN,

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borrowing arrangements and other funding sources; and (iv) the costs associated with transactions in the markets in which the fund invests.

which had already garnered significant interest and received over 400 comments. The need to reopen comment on those forms underscores how interconnected many of the SEC's current initiatives are, as well as the pitfalls and complexity of trying to address them piecemeal.

Proposed Guidance Regarding Cross-Trades

The Release sets forth proposed guidance relating to the use of cross-trading in response to investor redemptions. The proposed guidance is relatively limited, but reminds investment advisers that the requirement under Rule 17a-7 to effect the cross trade at the "current market price" may make less liquid assets ineligible to trade under Rule 17a-7. The Release suggests that for "assets that do not trade in active secondary markets," a fund should consider whether it can satisfy this condition of Rule 17a-7. For an adviser considering whether cross-trading would be an "effective and appropriate liquidity risk management tool," the Release suggests that the adviser consider its duty to seek best execution for each fund involved in the trade and its duty of loyalty to each fund, noting that it is necessary to consider any negative impact (including "risk-shifting") on a fund resulting from a potential cross-trade.

Compliance Dates

Liquidity Risk Management Program and Form N-PORT. The Release proposed two tiers of compliance dates for proposed Rule 22e-4 and related reporting requirements on proposed Form N-PORT. Funds that are part of a fund complex with net assets of $1 billion or more would be subject to a compliance date of 18 months after the effective date of the applicable rules resulting from the Release. Funds within a complex with less than $1 billion in net assets would be required to comply 30 months after the effective date.

Swing Pricing. The Release does not propose a compliance date for swing pricing because the use of swing pricing would be optional.

Form N-CEN. The Release proposes that the compliance date for changes to proposed Form N-CEN would be 18 months after the effective date of the applicable rules resulting from the Release.

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The Release's proposals, if adopted, would impose significant additional requirements on funds and their investment advisers to develop liquidity risk management programs that satisfy the applicable requirements. In addition, the use of swing pricing could substantially alter industry practices with respect to pricing of fund shares and change how costs associated with increased purchase or redemption activity are allocated to transacting shareholders. We expect a significant number of comments on the Release from various industry participants and other interested parties. Comments on the Release must be filed with the SEC within 90 days after the Release is published in the Federal Register.

If you would like to learn more about the issues in this Alert, please contact your usual Ropes & Gray attorney.