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What You Need to Know About the SEC's New Fund Liquidity Risk Management Proposal

SEC Proposes Liquidity Risk Management Program Requirements, Optional Swing Pricing, and Expanded Liquidity Disclosure for Open-End Funds

On Sept. 22, 2015, the Securities and Exchange Commission (the SEC) voted unanimously to propose a comprehensive, multi-layered set of new and amended rules and forms designed to promote effective liquidity risk management throughout the open-end fund industry (the Proposal or the Liquidity Proposal).[1] The Proposal is intended to (i) address liquidity-related developments from modern portfolio construction; (ii) reduce the risk that funds will be unable to meet redemption obligations; (iii) mitigate dilution of the interests of fund shareholders; and (iv) enhance transparency of fund liquidity and redemption practices. At the same time, the SEC re-opened the comment period for its Investment Company Reporting Modernization proposal, which was proposed for comment this past May (the Reporting Proposal).[2]

The Liquidity Proposal and the Reporting Proposal both come as part of a broader set of SEC initiatives to address the impact of open-end fund investment activities on investors and the financial markets, and the risks associated with increasingly complex portfolio composition and operations in the asset management industry. As outlined by SEC Chair Mary Jo White, these initiatives will also include measures to address the use of derivatives by funds, including imposing limits on leverage from fund use of derivatives (expected to be proposed by year-end); stress-testing requirements for large funds and advisers, as required by the Dodd-Frank Wall Street Reform and Consumer Protection Act; and transition planning for investment advisers.

The Liquidity Proposal has three major components:

- **Liquidity Risk Management Program Requirements**. A new Rule 22e-4 under the Investment Company Act of 1940 (the 1940 Act) would require each open-end fund, including all open-end exchange-traded funds (ETFs) but not including money market funds, to establish a liquidity risk management program, which must be approved by the fund's board of directors or trustees (Board) and incorporate specified required elements, including a detailed liquidity classification regime for portfolio holdings. This part of the Proposal is also intended to codify the SEC's existing "15% illiquidity" limitation.

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[1] Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release, SEC Release Nos. 33-9922, IC-31835 (Sept. 22, 2015) (the Proposing Release), *available at* https://www.sec.gov/rules/proposed/2015/33-9922.pdf.

[2] *See* Investment Company Reporting Modernization, SEC Release Nos. 33-9776, 34–75002, IC–31610 (May 20, 2015), 80 Fed. Reg. 33590 (June 12, 2015), *available at* https://federalregister.gov/a/2015-12779.

- **Swing Pricing Option**. Amendments to Rule 22c-1 under the 1940 Act would permit open-end funds (but not ETFs or money market funds) to use "swing pricing" – a method of adjusting net asset value per share (NAV) to pass on the costs of purchase or redemption activity to the shareholders associated with that activity. The SEC also proposed related recordkeeping amendments to Rule 31a-2 under the 1940 Act.

- **Disclosure and Reporting Requirements**. Amendments to current Form N-1A would require disclosure of fund policies concerning the redemption of fund shares and the use of swing pricing, and would require the filing of credit agreements. Amendments to previously proposed Forms N-PORT and N-CEN, which are part of the Reporting Proposal, would require disclosure of detailed information regarding the liquidity of a fund's holdings and the fund's liquidity risk management practices (including the liquidity classification of each portfolio holding, using the liquidity classification categories required by Rule 22e-4).

Comments on the Liquidity Proposal, as well as additional comments on the Reporting Proposal, are due within 90 days of publication of the Liquidity Proposal in the Federal Register (to date, it has not yet been published).

This Client Alert is designed to provide an overview of the key components of the Liquidity Proposal, as well as some of the statements and guidance on liquidity-related issues that are contained in the Proposing Release. The proposed compliance dates for the various elements of the Proposal are described at the end of this Client Alert.

I. Liquidity Risk Management Program Requirements

A. Adoption and Implementation of a Liquidity Risk Management Program

The SEC is proposing new Rule 22e-4, which would require each open-end fund, or series of a series fund (including ETFs, but not money market funds or ETFs classified as unit investment trusts), to adopt and implement a written liquidity risk management program (Liquidity Program or Program).[3] A fund's Liquidity Program must be reasonably designed to assess and manage the fund's "liquidity risk," defined in the Proposal 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."[4] The Program must include policies and procedures incorporating the required elements prescribed in the rule, as further described below, and be administered by the fund's investment adviser or an officer or officers of the fund (but not solely by the portfolio managers of the fund). Each fund (at the series level) would be required to tailor its Liquidity Program to the fund's own liquidity risk in order to comply with the rule; however, series of a series fund that are substantially similar in terms of cash flow patterns, investment strategies, portfolio liquidity and other factors required to be considered in assessing liquidity risk could adopt the same or similar Programs.[5]

B. Required Elements of a Liquidity Program

1. Classification of Portfolio Assets

Each fund would be required to classify and review on an ongoing basis each portfolio position, based on six classification categories identifying the number of days that the position is "convertible to cash" at a price that does not materially affect the value of the asset immediately prior to sale (convertible to cash means the ability to be sold, with the sale settled, within the stated number of days).[6] The classification should be determined using information obtained after reasonable inquiry. If the fund concludes that different portions of a position in a particular asset could be converted to cash within different times (*e.g.*, that 50% of the position could be converted to cash within one day, but the remainder of the position could take up to three days to convert to cash), then each portion of the position should be classified separately.[7]

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[3] Proposed Rule 22e-4.

[4] Proposed Rule 22e-4(a)(7).

[5] Proposing Release, *supra* note 1, at 46.

[6] Proposed Rule 22e-4(a)(3).

[7] Proposing Release, *supra* note 1, at 64-65.

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The six classification categories specified in the rule are:

a. convertible to cash within 1 business day;

b. convertible to cash within 2-3 business days;

c. convertible to cash within 4-7 calendar days;[8]

d. convertible to cash within 8-15 calendar days;

e. convertible to cash within 16-30 calendar days; or

f. convertible to cash in more than 30 calendar days.[9]

2. *Liquidity Classification Factors*

The convertible to cash classifications must be determined taking into account, at a minimum, the following factors, to the extent applicable, with respect to each asset (or similar assets, to the extent that data concerning the asset is unavailable) (the Classification Factors):

a. 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;

b. 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);

c. volatility of trading prices for the asset;

d. bid-ask spreads for the asset;

e. whether the asset has a relatively standardized and simple structure;

f. maturity and date of issue (for fixed-income assets);

g. restrictions on trading of the asset and limitations on transfer of the asset;

h. size of the fund's position in the asset relative to the asset's average daily trading volume and, as applicable, 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

i. relationship of the asset to another portfolio asset.[10]

3. *Assessment and Ongoing Review of Liquidity Risk*

Each fund would be required to assess and periodically review the fund's liquidity risk, considering, at a minimum, the following prescribed liquidity risk factors (the Liquidity Risk Factors):

a. the fund's short-term and long-term cash flow projections, taking into account:

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[8] A note to Rule 22e-4(b)(2)(i) states that where the period to convert could be viewed as either 2-3 business days or 4-7 calendar days, the fund should select the shorter period (*i.e.*, 2-3 business days).

[9] Proposed Rule 22e-4(b)(2)(i).

[10] Proposed Rule 22e-4(b)(2)(ii). The Proposing Release notes that assets placed in segregated accounts for use by a fund to "cover" derivatives and other transactions pursuant to SEC Release 10666 are available for sale to meet redemptions only once the related derivatives position is disposed of or unwound, and, therefore, a fund should classify the liquidity of these segregated assets using the liquidity of the derivative instruments they are covering. See Proposing Release, *supra* note 1, at 96.

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(i) the size, frequency, and volatility of historical purchases and redemptions of fund shares during normal and stressed periods;

(ii) fund redemption policies;

(iii) fund shareholder ownership concentration;

(iv) fund distribution channels; and

(v) degree of certainty associated with the fund's short-term and long-term cash flow projections;

b. the fund's investment strategy and liquidity of portfolio assets;

c. the fund's use of borrowings and derivatives for investment purposes; and

d. the fund's holdings of cash and cash equivalents, as well as borrowing arrangements and other funding sources.[11]

Proposed Rule 22e-4 does not include prescribed review procedures, nor does it incorporate specific developments that a fund must monitor or the frequency with which liquidity classifications of individual portfolio positions must be reviewed. The Proposing Release suggests that a fund may wish to determine the frequency of its review based on the liquidity of its portfolio holdings and the timing of its portfolio acquisitions and turnover, and that a fund should generally include policies and procedures for identifying marketwide developments, as well as security and asset-class specific developments that could demonstrate a need to change the liquidity classification of a portfolio position.[12] The Proposing Release notes that funds will, at a minimum, need to review the liquidity classification of each portfolio security monthly in order to accurately report this information on proposed Form N-PORT,[13] and it suggests that a fund whose portfolio assets' liquidity could depend significantly on current market conditions should conduct a review as frequently as daily, or even hourly, depending on facts and circumstances.[14]

4. Management of Liquidity Risk – Required Measures

a. *Three-Day Liquid Asset Minimum*
The fund must determine the fund's "three-day liquid asset minimum" – the percentage of the fund's net assets to be invested in three-day liquid assets – considering, at a minimum, the Liquidity Risk Factors.[15] The fund must periodically review (no less than semiannually) the adequacy of its three-day liquid asset minimum, considering the same factors.[16]

A **three-day liquid asset** is defined as cash held by a fund and any position of a fund in an asset (or portion of the fund's position in an asset) that the fund believes is convertible into cash within three business days at a price that does not materially affect the value of that asset immediately prior to sale (based on application of the Classification Factors described above).[17]

b. *Limit on Acquisition of Less Liquid Assets*
The fund may not acquire 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.[18]

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11 Proposed Rule 22e-4(b)(2)(iii).

12 Proposing Release, *supra* note 1, at 101-02.

13 *Id.* at 101 n. 253.

14 *Id.* at 101.

15 Proposed Rule 22e-4(b)(2)(iv)(A).

16 Proposed Rule 22e-4(b)(2)(iv)(B).

17 Proposed Rule 22e-4(a)(8).

18 Proposed Rule 22e-4(b)(2)(iv)(C).

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A **less liquid asset** is defined as any position of a fund in an asset (or portion of the fund's position in an asset) that is not a three-day liquid asset.[19]

c. *Limit on Acquisition of 15% Standard Assets (formerly known as "Illiquid Assets")*
The fund may not acquire 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.[20]

A **15% standard asset** is 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 (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).[21]

d. *Redemption-in-Kind Procedures*
The fund must 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.[22]

C. Board Approval and Oversight Requirements

1. *Initial Board Approval; Approval of Material Changes*
The fund would be required to obtain initial approval of its Liquidity Program (including the fund's three-day liquid asset minimum), as well as approval of any material change to the Program or its three-day liquid asset minimum, from the fund's Board, including a majority of the directors or trustees who are not "interested persons" of the fund, as defined in the 1940 Act (the Independent Board Members). [23]

2. *Board Review of Report on Adequacy and Effectiveness of Program*
The fund's Board, including a majority of the Independent Board Members, would be required to review, no less frequently than annually, a written report prepared by the fund's investment adviser or officers responsible for administering the fund's Liquidity Program (the Liquidity Program Administrator) that describes the adequacy of the fund's Liquidity Program, including the fund's three-day liquid asset minimum, and the effectiveness of its implementation.[24]

3. *Designation and Board Approval of Program Administrator*
The fund must designate the fund's Liquidity Program Administrator. The Liquidity Program Administrator cannot be solely one or more portfolio managers of the fund, although a portfolio manager can provide input.[25] The designation of the Liquidity Program Administrator must be approved by the Board, including a majority of the Independent Board Members.[26]

D. Recordkeeping Requirements

Each fund would be required to maintain:

a. a written copy of the fund's Liquidity Program policies and procedures (in effect at any time within the past five years) in an easily accessible place;

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[19] Proposed Rule 22e-4(a)(6).

[20] Proposed Rule 22e-4(b)(2)(iv)(D). The 15% standard asset limitation is intended to codify the SEC's existing guidance that that an open-end fund should invest no more than 15% of its net assets in "illiquid" assets. *See* Proposing Release, *supra* note 1, at 152-53. Note, however, that while the current guidance and the text of the Proposing Release refer to a limit of 15% of net assets, the text of the proposed rule refers to 15% of total assets.

[21] Proposed Rule 22e-4(a)(4).

[22] Proposed Rule 22e-4(b)(2)(iv)(E).

[23] Proposed Rule 22e-4(b)(3)(i).

[24] Proposed Rule 22e-4(b)(3)(ii).

[25] *See* Proposing Release, *supra* note 1, at 177-78.

[26] Proposed Rule 22e-4(b)(3)(iii).

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b. copies of any materials provided to the Board in connection with its approval(s) and written reports on the adequacy and effectiveness provided to the Board, for at least five years after the end of the fiscal year in which the documents were provided, the first two years in an easily accessible place; and

c. a written record of how the three-day liquid asset minimum, and any adjustments thereto, were determined, including assessment of the Liquidity Risk Factors, for a period of not less than five years (the first two in an easily accessible place) following the determination of, and each change to, the three-day liquid asset minimum.[27]

E. Additional Liquidity Risk Management Tools

The Proposing Release notes that many funds currently engage in certain practices that would not be required by proposed Rule 22e-4, but which could enhance a fund's ability to manage liquidity risk. The Proposing Release identifies several examples of these practices, and provides guidance (or proposed guidance) for funds engaging in them.

- **Borrowing.** A fund may enter into borrowing arrangements and agreements with other potential funding sources that could be used to pay redeeming shareholders without the need to sell portfolio securities at significantly discounted prices.[28]

- **Purchasing ETFs.** Some funds may invest a portion of their assets in ETFs with strategies similar to the fund's investment strategy because they view ETF shares as having characteristics that enhance the liquidity of the fund's portfolio.[29]

- **Suspension of Redemptions and Delayed Payment of Proceeds.** Rule 22e-3 permits a money market fund to suspend redemptions and postpone payment of redemption proceeds in an orderly liquidation of the fund if, subject to other requirements, the fund's Board makes certain findings. The SEC requests comment on whether the relief provided by Rule 22e-3 should be available to types of open-end funds besides money market funds, and whether the SEC should consider proposing rules that would permit funds to suspend redemptions under other circumstances not involving the liquidation of the fund.[30]

- **Cross-Trading.** Subject to the conditions of Rule 17a-7 under the 1940 Act, funds are permitted to engage in "cross-trading," that is, securities transactions with certain of their affiliated persons, including other funds within the fund family. The Proposing Release recognizes that some funds may seek to use cross-trading as an additional liquidity risk management tool, but notes that Rule 17a-7 includes conditions that limit the portfolio assets that may be cross-traded and thus cross-trades that involve certain less liquid assets may not be eligible to rely on the Rule 17a-7.

The Proposing Release includes the following proposed guidance relating to the use of cross-trading in response to investor redemptions.

- A fund's adviser should consider its duty to seek best execution for each fund potentially involved in the cross-trading transaction, as well as its duty of loyalty to each fund.

- An adviser should not cause funds to enter into a cross-trade unless doing so would be in the best interests of each fund participating in the transaction.

- In assessing these factors, a fund should consider any negative impact on the fund resulting from the purchase of assets by one fund from an affiliated fund (that is, whether any risk-shifting between funds that results from trading assets is appropriate, considering the funds' strategies, risk profile and liquidity needs before the transaction takes place), given the policy of each fund as recited in its registration statement and reports under the 1940 Act.[31]

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[27] Proposed Rule 22e-4(c).

[28] See Proposing Release, *supra* note 1, at 164-65 (referring to guidance provided in connection with Proposed Rule 22e-4(b)(2)(iii)(D)).

[29] See Proposing Release, *supra* note 1, at 165-67.

[30] See Proposing Release, *supra* note 1, at 167-69.

[31] See Proposing Release, *supra* note 1, at 171-74.

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II. Swing Pricing Option

A. Proposed Rule 22c-1(a)(3)

Rule 22c-1 under the 1940 Act, the SEC's "forward pricing" rule, requires each fund, as well as its principal underwriters and dealers, to sell and redeem fund shares at a price based on current NAV next computed after receipt of an order to purchase or redeem fund shares. Proposed new paragraph (a)(3) of Rule 22c-1 would provide an exception to the requirement to price fund shares at NAV to permit "swing pricing" under certain circumstances.[32] The swing pricing option would be available to all open-end funds other than ETFs and money market funds. A feeder fund in a master-feeder arrangement may not use swing pricing to adjust the feeder fund's NAV, but the master fund may use swing pricing to adjust the master fund's NAV.[33]

The Proposal defines swing pricing as "the process of adjusting a fund's current net asset value per share to mitigate dilution of the value of its outstanding redeemable securities as a result of shareholder purchase and redemption activity, pursuant to the requirements set forth in [the rule]."[34] A fund using swing pricing would adjust its NAV by a "swing factor" when the level of net redemptions from the fund has exceeded the fund's "swing threshold." The NAV as so adjusted would be the NAV reported in the fund's financial statements and used to calculate performance.[35]

Swing pricing is designed to mitigate dilution of non-transacting shareholders from high-volume purchase and sale activity. The SEC's proposal to permit swing pricing is based on models developed in Europe and other jurisdictions as well as proposals from a number of U.S. fund groups concerned about the dilution impact on non-transacting shareholders from high-volume redemption and purchase activity by others.

B. Optional Adoption of Swing Pricing Policies and Procedures

Under proposed Rule 22c-1(a)(3), a fund would be able to use swing pricing to adjust its current NAV to mitigate dilution of the value of its outstanding redeemable securities as a result of shareholder purchase and redemption activity, provided that it has established and implemented swing pricing policies and procedures in compliance with Rule 22c-1(a)(3) (Swing Pricing Policy or Policy). While adopting a Swing Pricing Policy is optional, once the fund adopts such a Policy, it must use swing pricing when the swing threshold specified in the Policy is exceeded, unless the Board approves termination or suspension of the Policy.[36]

C. Required Elements of a Swing Pricing Policy

A fund's Swing Pricing Policy must include the following elements.

1. Swing Threshold

The Policy must specify the fund's swing threshold, which is the amount of net purchases into or net redemptions from the fund, expressed as a percentage, that triggers the initiation of swing pricing.[37] The swing threshold must be based on consideration of 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.[38]

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[32] Proposed Rule 22c-1(a)(3).

[33] Proposed Rule 22c-1(a)(3)(iv).

[34] Proposed Rule 22c-1(a)(3)(v)(C).

[35] Proposing Release, *supra* note 1, at 240-41, 246.

[36] Proposed Rule 22c-1(a)(3)(ii)(A).

[37] Proposed Rule 22c-1(a)(3)(v)(D).

[38] Proposed Rule 22c-1(a)(3)(i)(B).

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2. ***Periodic Review of Swing Threshold***
The Policy must provide for the periodic review, no less frequently than annually, of the fund's swing threshold, taking into account the same factors prescribed for establishing the swing threshold.[39]

3. ***Swing Factor***
The Policy must specify how the swing factor shall be determined, and whether the swing factor would be subject to any upper limit. These determinations must take into account:

    - 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 to adjust the fund's net asset value per share, including any market impact costs, spread costs, and transaction fees and charges[40] arising from asset purchases or asset sales to satisfy those purchases or redemptions, as well as any borrowing-related costs associated with satisfying redemptions; and

    - 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 to adjust the fund's net asset value per share, if that information would not be reflected in the current net asset value of the fund computed that day.[41]

4. ***Mandatory Application of Swing Factor to Adjust NAV***
The Policy must provide that the fund must adjust its NAV by the swing factor once the level of net purchases into or net redemptions from the fund has exceeded the swing threshold. In determining whether the swing threshold has been exceeded:

    - the person responsible for the determination may make such determination on the basis of information obtained after reasonable inquiry;[42] and

    - purchases or redemptions that are made in kind and not in cash must be excluded.[43]

D. Approval and Oversight Requirements

1. ***Board Approval of Policy, Material Changes, and Termination or Suspension***
Under the Proposal, if a fund adopts a swing pricing policy, the fund's Board, including a majority of the Independent Board Members, must approve (i) the swing pricing policies and procedures; (ii) the swing threshold; (iii) any swing factor upper limit; (iv) any material change to the policies and procedures, swing threshold, or swing factor upper limit; and (v) any decision to suspend or terminate the swing pricing policies and procedures.[44]

2. ***Board Designation of Responsible Person(s)***
A fund's Board would be required to designate the fund's investment adviser or officers responsible for administering the swing pricing policies and procedures and determining the swing factor to be used each time the swing threshold is breached. Determination of the swing factor would be required to be reasonably segregated from the portfolio management function of the fund.[45]

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[39] Proposed Rule 22c-1(a)(3)(i)(C).

[40] Transaction fees and charges are defined as brokerage commissions, custody fees, and any other charges, fees and taxes associated with portfolio asset purchases and sales. Proposed Rule 22c-1(a)(3)(v)(E). The Proposing Release identified transfer taxes and repatriation costs for certain foreign securities or transaction fees associated with portfolio investments in other investment companies as examples of "other charges, fees and taxes associated with portfolio assets purchases and sales." Proposing Release, *supra* note 1, at 223.

[41] Proposed Rule 22c-1(a)(3)(i)(D).

[42] Because the deadline by which a fund must strike its NAV may precede the time that a fund receives final information concerning daily net flows from the fund's transfer agent, 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. Proposing Release, *supra* note 1, at 239.

[43] Proposed Rule 22c-1(a)(3)(i)(A).

[44] Proposed Rule 22c-1(a)(3)(ii)(A).

[45] Proposed Rule 22c-1(a)(3)(ii)(B).

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E. Recordkeeping

A fund that adopts a swing pricing policy would be required to maintain in an easily accessible place a written copy of the fund's swing pricing policies and procedures in effect at any time within the past six years.[46] The SEC has also proposed amendments to Rule 31a-2 under the 1940 Act that would require the fund to maintain records supporting swing pricing computations. More specifically, these amendments to Rule 31a-2 would require a fund that adopts swing pricing policies and procedures to preserve records evidencing and supporting each computation of an adjustment to the fund's NAV based on the fund's swing pricing policies and procedures. These records would generally 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 NAV; and relevant data supporting the calculation of the swing factor.[47] These records would be required to be maintained for at least six years from the date that the NAV adjustment occurred (the first two in an easily accessible place).[48]

F. Looking to Europe as an Example and Considering an Alternative Approach

In the Proposing Release, the SEC emphasized that the swing pricing policies contemplated by the proposed rule are similar to those already used by certain foreign funds, noting that investment management industry representative associations operating in certain European jurisdictions, including Luxembourg (a significant jurisdiction for the organization of UCITS funds in Europe), have adopted guidelines on swing pricing procedures. According to sources cited by the SEC in the Proposing Release, swing pricing has been found to benefit fund performance over the long term.[49]

Swing pricing policies of foreign funds can be grouped into two categories: "partial swing pricing" and "full swing pricing." The SEC has proposed partial swing pricing for U.S. funds, meaning that under this regime, an NAV adjustment would not be permitted unless net purchases or net redemptions exceed a threshold set by the fund and approved by the fund's Board. While a number of foreign funds use partial swing pricing, others use full swing pricing. With full swing pricing, an NAV adjustment is made anytime a fund experiences net purchases or net redemptions. In the Proposing Release, the SEC acknowledged the pros and cons of each approach, but stated its belief that partial swing pricing would generally cause lower NAV volatility than full swing pricing.[50]

III. Disclosure and Reporting

Currently, funds are not expressly required to disclose how they manage the liquidity of their assets. Only limited information is available about whether fund liquidity corresponds to redemption needs. The disclosure and reporting provisions in the Proposing Release are designed to provide more transparency and consistency of disclosure about fund liquidity to the SEC, investors and other market participants. The SEC has proposed the following amendments to current Form N-1A and proposed Forms N-PORT and N-CEN.

A. Disclosure and Reporting Relating to Liquidity Risk Management Generally

1. Proposed Amendments to Form N-1A

Proposed amendments to Form N-1A would require the following:

- **Disclosure of Fund Policies Concerning the Redemption of Fund Shares.** Under a proposed amendment to Item 11 of Form N-1A, a fund would be required to disclose (i) the number of days following receipt of shareholder redemption requests in which the fund will pay redemption proceeds to redeeming investors (by distribution channel, if the number of days differs); (ii) the methods the fund uses to meet redemption requests

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[46] Proposed Rule 22c-1(a)(3)(iii).

[47] Proposing Release, supra note 1, at 237.

[48] Proposed Rule 31a-2(a)(2).

[49] Proposing Release, supra note 1, at 194 – 95 & nn. 440 – 41 (citing BlackRock, *Swing Pricing: The Dilution Effects of Trading Activity* (Dec. 2011), *available at* http://www2.blackrock.com/content/groups/internationalsite/documents/literature/ 1111157589.pdf; Association of the Luxembourg Fund Industry, *Swing Pricing: Survey, Reports & Guidelines* (Feb. 2011), *available at* http://www.alfi.lu/sites/alfi.lu/files/ALFI_Swing_Pricing.pdf).

[50] Proposing Release, supra note 1, at 198-99.

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(*e.g.*, sales of portfolio assets, holdings of cash or cash equivalents, lines of credit, interfund lending, in-kind redemptions); and (iii) whether those methods are used regularly or only in stressed market conditions.[51]

- **Filing Credit Agreements as Exhibits.** Under a proposed amendment to Item 28 of Form N-1A, a fund would be required to file as an exhibit to its registration statement any agreements related to lines of credit for the benefit of the fund (specific fees paid in connection with credit agreements need not be disclosed in the exhibit filed). Money market funds, like other funds, would be subject to this requirement.[52]

2. ***Proposed Amendments to Form N-PORT***

Proposed amendments to previously proposed Form N-PORT would require each fund to report the following data on a monthly basis. Such information filed for the last month of each quarter would be publicly available 60 days after the end of the quarter.[53]

- **Disclosure of Three-Day Liquid Asset Minimum.** A fund would be required to disclose its three-day liquid asset minimum.[54]

- **Liquidity Classifications for Portfolio Assets.** A fund would be required to disclose (i) the liquidity classification for each portfolio asset or portion thereof, using the six categories specified in Rule 22e-4 (described above in Section I.B.1),[55] and, for portfolio assets with multiple liquidity classifications, indicating the dollar amount of fund assets attributable to each classification; and (ii) for each portfolio asset, whether it is a 15% standard asset.[56]

3. ***Proposed Amendments to Form N-CEN***

Proposed amendments to previously proposed Form N-CEN would require each fund to report the following data on an annual basis:

- **Disclosure of Liquidity Risk Management Practices**. A fund would be required to disclose information about availability and use of lines of credit, interfund lending, interfund borrowing, and swing pricing during the reporting period. Money market funds would also be subject to the disclosure requirements concerning lines of credit and interfund lending and borrowing.[57]

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[51] Proposed Form N-1A Item 11(c)(7)-(8).

[52] Proposed Form N-1A Item 28(h).

[53] Proposing Release, *supra* note 1, at 257 n. 561.

[54] Proposed Form N-PORT Item B.7.

[55] The six classification categories are a) convertible to cash within 1 business day; 2) convertible to cash within 2-3 business days; 3) convertible to cash within 4-7 business days; 4) convertible to cash within 8-15 business days; 5) convertible to cash within 16-30 business days; or 6) convertible to cash in more than 30 calendar days.

[56] Proposed Form N-PORT Items C.7 and C.13. The Proposing Release notes that the SEC received several comments on the Reporting Proposal addressing the proposal to require funds to identify on proposed Form N-PORT whether an investment is an illiquid asset, in particular expressing concern that public dissemination of a fund's liquidity determinations could lead to misinterpretation and confusion among investors, particularly because of the subjective nature of such determinations. The SEC explained its determination to require disclosure of even more detailed information concerning liquidity determinations as follows (footnotes omitted):

> While we appreciate commenters' concerns and request further comment, we believe that the liquidity-related data reported on Form N-PORT that is made publicly available would inform investors and assist users in assessing funds' relative liquidity and the overall liquidity of the fund industry and of particular investment strategies and would not be confusing to investors. For example, third-party data analyzers could use the reported information to produce useful metrics for investors about the relative liquidity of different funds with similar strategies. We also anticipate that this publicly available data would provide a resource for fund managers to compare the liquidity classifications assigned to various portfolio assets, which in turn could result in making the liquidity classifications assigned to certain positions more consistent across the fund industry, to the extent appropriate, and could provide greater market transparency as to the liquidity characteristics of certain assets.

Proposing Release, *supra* note 1, at 259.

[57] Proposed Form N-CEN Item 44.

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- **Additional Disclosure for ETFs.** An ETF would be required to disclose whether the ETF 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.[58]

B. Additional Disclosure Required for Funds that Use Swing Pricing

Funds that have adopted swing pricing policies would be required to disclose and report the following additional information:

1. Proposed Amendments to Form N-1A

A fund that has adopted a swing pricing policy would be required to disclose the following information pursuant to Form N-1A:

- In discussing the purchase and sale of fund shares, a fund would be required to disclose the circumstances under which swing pricing would be used and the effects of using swing pricing. With respect to any portion of a fund's assets that is invested in other registered funds, the fund would disclose that 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 the effects of using swing pricing.[59]

- In its financial highlights, a fund would be required to disclose the per share impact of amounts related to swing pricing, and its NAV at the beginning and end of the period should be as adjusted by swing pricing.[60]

- In calculating its performance data, a fund would be required to use NAV as adjusted by swing pricing as both beginning NAV and ending redeemable value.[61]

- Notably, the Proposal would not require funds to publicly disclose their swing thresholds.[62]

2. Financial Statement Disclosure

A fund that has adopted a Swing Pricing Policy would be required to use the fund's NAV as adjusted by swing pricing in its statement of assets and liabilities and its statement of changes in net assets.[63] In addition, a fund using swing pricing would be required to report in the notes to its financial statements (i) the general methods used to determine whether the NAV will swing; (ii) whether the NAV has swung during the year; and (iii) the general effects of swing pricing on the fund's financial statements.[64]

IV. Compliance Dates

A. Liquidity Risk Management Programs

The SEC is proposing a phased compliance period to implement the liquidity risk management program required by Rule 22e-4, which would be based on the asset size of the fund or "group of related investment companies" – defined as two or more management companies (including series thereof) that (i) hold themselves out to investors as related companies for purposes of investment and investor services; and (ii) either (A) have a common investment adviser or have investment advisers that are affiliated persons of each other or (B) have a common administrator.[65] The proposed compliance dates are as follows:

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58 Proposed Form N-CEN Item 60.g.

59 Proposed Form N-1A Item 6(d).

60 Proposed Form N-1A Item 13, Instructions 2(d) and (e).

61 Proposed Form N-1A Item 13, Instructions 3(a) and (d); Item 26(b)(1), Instruction 4; Item 26(b)(2), Instruction 6; Item 26(b)(3), Instruction 6.

62 Proposing Release, *supra* note 1, at 200.

63 Proposed Reg. S-X Rule 6-04 Item 19; *see* Proposing Release at 246-47.

64 Proposed Reg. S-X Rule 6-03(n).

65 This is the same definition used in Rule 0-10 of the 1940 Act.

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- for larger entities (or groups of related investment companies) with net assets of $1 billion or more at the end of the most recent fiscal year – 18 months after the effective date; and

- for smaller entities (or groups of related investment companies) with net assets of less than $1 billion – 30 months after the effective date.

The compliance policies and procedures that satisfy the requirements of Rule 22e-4 must have been adopted, implemented and approved by the Board on or before the applicable compliance date.

B. Swing Pricing
The SEC is not proposing a compliance date for Rule 22c-1(a)(3) because adoption of swing pricing would be optional; however, a fund would be permitted to rely on the rule after the effective date as soon as it could comply with the requirements of the rule (including the recordkeeping, financial reporting and prospectus disclosure requirements).

C. Amendments to Form N-1A
The SEC is proposing to require all initial registration statements and post-effective amendments that are annual updates filed six months or more after the effective date to comply with the proposed amendments to Form N-1A.

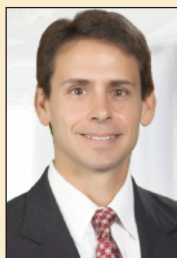
D. Amendments to Proposed Form N-PORT
The SEC is proposing a phased compliance period for compliance with the proposed amendments to proposed Form N-PORT as follows:

- for larger entities – 18 months after the effective date; and

- for smaller entities – 30 months after the effective date.

E. Amendments to Proposed Form N-CEN
The SEC is proposing a compliance date of 18 months after the effective date.

Ruth S. Epstein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