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SEC PROPOSES LIQUIDITY RISK-MANAGEMENT RULES

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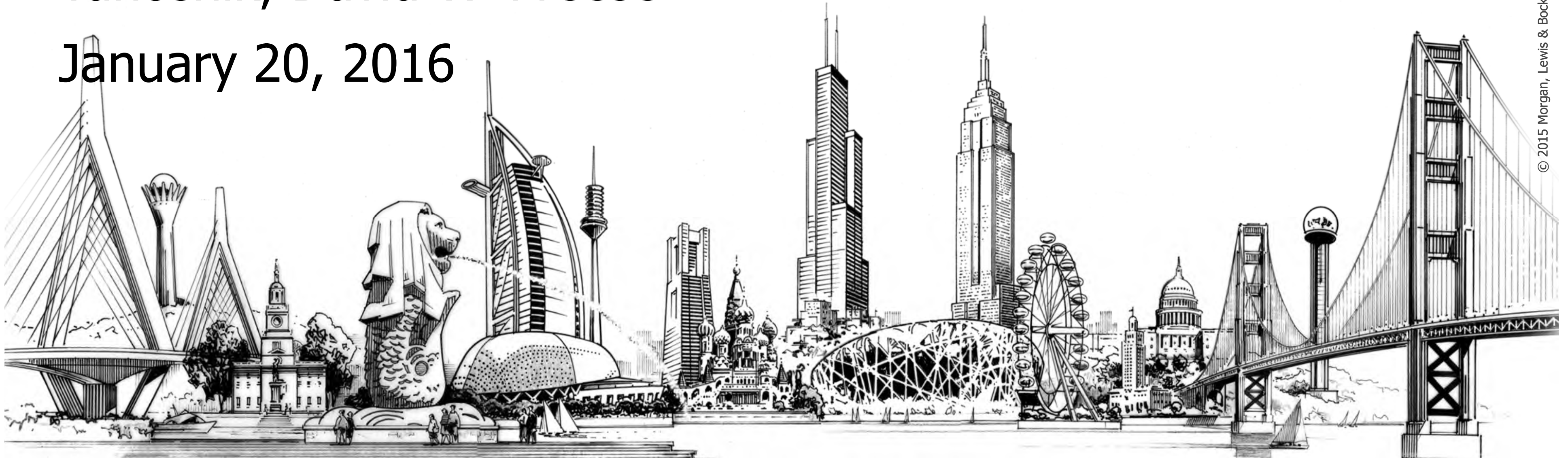

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Overview

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- Liquidity Risk Management Program
- Swing Pricing
- Disclosure and Reporting Requirements
- Miscellaneous Topics
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ESTABLISHING A LIQUIDITY RISK-MANAGEMENT PROGRAM

Liquidity Risk Management Program

- A fund would be required to establish and implement a written liquidity risk management program.
- The program would require:
  - Classification of the liquidity of fund portfolio assets and ongoing review;
  - Assessment, periodic review and management of a fund's liquidity risk;
  - Establishment of a three-day liquid asset minimum;
  - Cap on "15% Standard Assets;" and
  - Board approval and review.
- The program would apply to mutual funds and other open-end investment companies, including ETFs.
  - Excludes money market funds.
- A fund must designate the fund's investment adviser or officers to administer the program.

Classifying Portfolio Liquidity

- Fund must classify each portfolio position according to its relative liquidity. Essentially:
  - The person responsible for classifying the liquidity of each portfolio position must determine
  - using information obtained after reasonable inquiry
  - the number of days it would take the fund to sell a position
  - at a price that does not materially affect the value of that asset immediately prior to sale
  - and settle the sale (*i.e.*, receive cash for the sale of the asset).
- The fund must then conduct an ongoing review of its classification.

Classifying Portfolio Liquidity

- Who is responsible for classification?
  - Investment adviser or fund officers.
- What is "reasonable inquiry?"
  - Proposed Rule does not define the term.
  - Proposing Release notes that SEC staff would examine whether factors required by the Proposed Rule were considered.
  - Therefore, reasonable inquiry at least includes consideration of required factors.
  - Proposed Rule requests comment on whether the term is sufficiently clear. Therefore, clarity may come in the adopting release.

Classifying Portfolio Liquidity

- Funds must consider the following factors when classifying portfolio positions:
  - Existence of an active market for the asset, including whether the asset is listed on an exchange, as well as the number, diversity and quality of market participants;
  - Frequency of trades or quotes and average daily trading volume;
  - Volatility of trading prices;
  - Bid-ask spreads;
  - Standardization and simplicity of structure;
  - Maturity and date of issue for fixed income assets;
  - Restrictions on trading and limitations on transfer;
  - Size of position in an asset relative to the asset's average daily trading volume and, as applicable, number of units of the asset outstanding; and
  - Relationship of asset to another portfolio asset.

Classifying Portfolio Liquidity

- Classification is based on the number of days it would take to convert positions to cash at a price that does not materially affect the value of that asset immediately prior to sale.
- 6 Categories:
  - 1 business day;
  - 2-3 business days;
  - 4-7 calendar days;
  - 8-15 calendar days;
  - 16-30 calendar days; and
  - 30 or more calendar days.
- A fund could determine that different portions of a position in a particular asset could be converted to cash within different times.
- If the period to convert a position falls in both the 2-3 business day or 4-7 calendar category, the position should be classified in the 2-3 business day category.
- If conversion would take 4-7 days or longer, the position would be a "less liquid asset," if shorter, "a three-day liquid asset."

Classifying Portfolio Liquidity

- Value of the Asset "Immediately Prior to Sale"
  - Fund must determine whether the sales price the fund would receive is reasonably expected to move the price of the asset in the market.
  - Fund is not required to determine price of an asset immediately prior to sale.
- Classification must include time to settle
  - If the period to convert a position falls in both the 2-3 business day or 4-7 calendar category, the position should be classified in the 2-3 business day category.

Ongoing Review of Classification

- Ongoing review of the liquidity classification factors is required.
- There are no set procedures or requirements for the ongoing review of the liquidity classification factors within the proposed rule.
- The proposed rule suggests:
  - To determine how often liquidity classifications must be reviewed, a fund should consider the liquidity of its portfolio and the timing of its portfolio acquisitions and turnover.
    - Reviews can be as frequent as hourly or, at the maximum, monthly to comply with Form N-PORT.
  - To establish ongoing review policies and procedures, a fund should generally include policies to identify market-wide developments, as well as security and asset-class developments, that could necessitate a change in the liquidity classification of a portfolio position.

Assessing Liquidity Risk

- A fund must assess and periodically review liquidity risk.
  - 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.
- Liquidity risk assessment factors:
  - Short-term and long term cash flow projections, taking into account the following:
    - Size, frequency and volatility of historical purchases and redemptions of fund shares during normal and stressed periods;
    - A fund's redemption policies;
    - A fund's shareholder ownership concentration;
    - A fund's distribution channels; and
    - The degree of certainty associated with a fund's short-term and long-term cash flow projections.
  - A 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 wells as borrowing arrangements and other funding sources.

Periodic Review of Liquidity Risk

- Fund would be required to consider each of these factors in periodically reviewing its liquidity risk.
- Fund may establish procedures for evaluating regulatory, market and fund-specific developments.
- No other requirements with respect to the periodic review.

Three-Day Liquid Asset Minimum

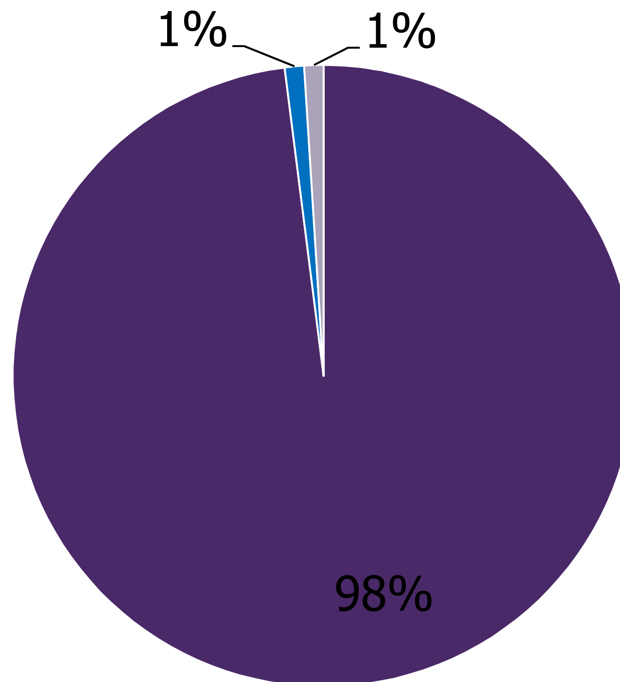
- A fund would be required to determine a minimum percentage of its net assets that must be invested in cash and assets that are convertible to cash within three business days at a price that does not materially affect the value of the assets immediately prior to sale.
- The three-day liquid asset minimum:
  - Would be determined by a fund based on the liquidity risk factors and must be approved by the board.
  - Must be reviewed at least semi-annually.
  - May vary among funds.
- A written record of how a fund determines its three-day liquid asset minimum must be maintained within the fund records.
- A fund cannot acquire "less liquid assets" if immediately after the acquisition the fund would have less than the minimum invested in three-day liquid assets.

Example

Fund Assets

Characteristics decreasing liquidity risk

- Diverse shareholder base
- Multiple broker-dealers
- No derivatives
- Line of credit



Characteristics increasing liquidity risk

- High percentage of bank loans
- History of volatile cash flows
- Market stress and lower performance has increased redemptions
- 5% net redemptions in one week

15% Limit on Illiquid Assets

- The proposed rule would formalize the SEC guidance that limits a fund's ability to invest in illiquid assets to 15% of the fund's net assets.
- Specifically, a fund would be prohibited from acquiring any "15% standard asset" if immediately after the acquisition the fund would have invested more than 15% of its net assets in "15% standard assets."
  - A 15% standard asset is: any asset that may not be sold or disposed of in the ordinary course of business within seven calendar days at approximately the value ascribed to it by the fund.
- Distinct from three-day liquid asset determinations
  - A fund would not need to consider the size of a fund's position in an asset or the number of days needed to convert the asset to cash.
- The 15% limitation would have to be monitored through the liquidity risk management program.

Example 1

- Fund owns 5% of the outstanding stock of a small cap issuer.
- Fund determines that:
  - 60% of its position can be converted to cash in 3 business days.
  - 40% of its position can be converted to cash in 6 business days.
- Fund also determines that it could sell a standard lot of the issuer in 5 days.
- Under this scenario:
  - 60% of its position would be considered a three-day liquid asset and could be counted as part of the fund's three day liquid asset minimum.
  - 40% of its position could <u>not</u> be counted as part of the fund's three day liquid asset minimum.
  - The entire position would not count against the fund's 15% cap on illiquid assets.

Example 2

- Fund owns a corporate bond.
- Fund determines it can sell the bond in 7 days, but that the sale will not settle until the 10th day.
- Under this scenario:
  - The fund would be required to classify the bond as falling within the 8-15 day liquidity category.
  - The bond still would not count against the fund's 15% cap on illiquid assets.

Board Responsibility

- The board, including the majority of the board's independent directors, must approve:
  - The liquidity risk management program, including the three-day liquid asset minimum;
  - Any material changes to the liquidity risk management program; and
  - The designation of the investment adviser or officers tasked with administering the liquidity risk management program.
- The board must review a written report that assesses the adequacy of the program.
  - The report is provided at least annually from the investment adviser or officers administering the program.

USE OF SWING PRICING

Background

- The costs arising from trading activity from shareholder purchase or redemption requests can dilute the value of the existing shareholders' interests.
- Dilution occurs because the trading costs are not reflected in the price the purchasing/redeeming shareholders' receive.
  - Per Rule 2a-4 – changes in portfolio holdings and number of shares are generally reflected in NAV the next business day
- Swing pricing is a process that anticipates these trading costs and accounts for them when calculating NAV in order to pass on these costs to the purchasing and redeeming shareholders.
  - NAV moves upward when shares are purchased so that the purchasing shareholder pays the transaction costs from the fund's purchase of additional portfolio assets.
  - NAV moves downward when shares are redeemed so that the redeeming shareholder pays the transaction costs from the fund's sale of portfolio assets.
- Swing pricing is designed to protect existing shareholders and can be used as part of the fund's liquidity risk management program.

Proposed Amendments

- Rule 22c-1 of 1940 Act requires funds to sell and redeem shares at NAV, which may not reflect the full effect of the purchase or redemption on the NAV.

  – E.g., NAV does not reflect costs of selling portfolio securities to make cash available to pay the redemption

- Swing pricing would allow a fund to adjust the value at which investors purchase or redeem their shares when shareholder redemptions or purchases <u>surpass certain thresholds</u> that have been pre-approved by the fund's board.

Proposed Amendments (con't)

- The amendments would permit, but not require, open-end funds, other than money market funds and ETFs, to use swing pricing.
  - Swing pricing could impede the effective functioning of an ETF's arbitrage mechanism – APs would not be able to assess whether an arbitrage opportunity exists if swing pricing was used
  - ETFs typically externalize transactions costs to APs who purchase and sell creation units (fees vary depend on cash or in-kind transactions)
  - Money market funds are permitted to impose liquidity fees, which serve a similar purpose as the NAV adjustments contemplated by swing pricing
- Swing pricing and swing thresholds can be determined on a fund by fund basis.
- Once swing pricing is adopted by the fund, the fund is required to use swing pricing.

Implementing Swing Pricing

- To use swing pricing a fund must implement policies and procedures to allow a fund to adjust its current NAV to prevent dilution upon certain triggering events.
  - The amount the current NAV is adjusted is called the "swing factor."
- The Board would need to determine a "swing threshold" for a fund.
  - The level of net purchases into or net redemptions from the fund (stated as a percentage of the fund's NAV) that triggers swing pricing.
- If the swing threshold is triggered, the swing factor would be applied.
- The swing threshold would not be publicly disclosed:
  - Investors may seek to "time" their transactions based on this information
  - Could mislead investors regarding relative risks of funds (i.e., lower thresholds equal more risky funds)

Swing Threshold

- A fund would adopt policies and procedures to determine the appropriate swing threshold for the fund based on its consideration of the following factors:
  - The size, frequency and volatility of historical net purchase and 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 (e.g., market impact costs, spread costs, brokerage commissions and custody fees)
  - Note: first three factors also need to be considered when assessing a fund's liquidity risk
- To be effective in mitigating dilution "a fund's swing threshold should generally reflect the estimated point at which net purchases or net redemptions would trigger the fund's investment adviser to trade portfolio assets in the near term, to a degree or of a type that may generate material liquidity or transaction costs for the fund."
  - Significant trading of portfolio assets
  - Trading of less liquid assets in short periods of time

Swing Threshold (con't)

- There is no minimum "floor" requirement – Board should determine what is appropriate for a particular fund.
  - However, the SEC envisions "partial swing" pricing – not "full swing" pricing – because funds would likely want to avoid the NAV volatility associated with full swing pricing
  - Full swing pricing is when NAV is adjusted whenever there is *any* level of net purchases/redemptions
- When determining whether the swing threshold has been exceeded, in-kind purchases and redemptions would not be included.
- The swing threshold must be reviewed annually and any changes to the threshold require board approval.
  - Evaluate market-wide and fund-specific developments
- SEC cautioned funds from selectively disclosing their swing thresholds to only certain shareholders – similar to disclosure of fund portfolio holdings.

Swing Threshold (con't)

- A fund must monitor shareholder trades and the flow of money to determine whether the swing threshold is triggered.
- The fund can make the determination whether net purchases/redemptions have exceeded the swing threshold based on information obtained after reasonable inquiry.
  - As a result, to use swing pricing on a given day, the net cash flows for a fund must be known or estimated after reasonable inquiry.
  - Fund would need to establish processes for communicating with its service providers and intermediaries in order to obtain interim data regarding fund flows

Swing Factor

- A fund would adopt policies and procedures to determine the appropriate swing factor (the amount, expressed as a percentage of NAV) by which the fund adjusts its NAV per share when the fund has exceeded its swing threshold) based on its consideration of the following factors:
  - any near-term costs expected to be incurred from net purchases or net redemptions that occur on the day the swing factor is utilized.
    - These costs include: market-related costs (market impact costs and spread costs); transaction-related fees; and any borrowing-related costs associated with satisfying redemptions.
    - "Near term costs" include costs incurred by the Fund over the course of several days (e.g., to rebuild Fund cash balances depleted by satisfying such redemption requests).
    - A Fund could consider some of the same factors it would evaluate for purposes of classifying the liquidity of its portfolio in order to assess the costs of buying or selling portfolio assets.
      - E.g., widening bid ask spreads may indicate increased market-related costs associated with that investment
- The SEC acknowledges that a fund will likely have to estimate these costs resulting in the swing factor being an estimate of the combined near-term costs associated with purchase or redemption transactions.

Swing Factor (con't)

- The swing factor policies and procedures must take into account the value of assets purchased or sold by a fund as a result of shareholder purchases or redemptions on the day the swing factor is used, BUT only if the information is not already reflected in the fund's current NAV for that day.
  - Fund NAVs generally do not reflect changes in portfolio holdings and number of shares until the next business day.
- Swing factor considerations are expected to vary by fund and should incorporate an assessment of multiple sources of dilution.
- Calculating the swing factor:
  - A fund can take different approaches since relevant factors may vary.
    - A fund may set a "base" swing factor that would be adjusted as needed (e.g., if spread costs exceed a certain pre-determined level)
    - The proposal also considers the use of a formula or algorithm that includes various factors
    - Policies and procedures may incorporate the use of reasonable estimates when determining the swing factor

Swing Factor (con't)

- There would not be an "upper limit" requirement, but a fund may adopt an upper limit at their discretion.
  - The SEC acknowledged the difficulty of establishing a "one size fits all" limit under all market conditions for all funds.
  - Reliance on fund boards to set the appropriate limit (acting in the best interests of fund and considering all applicable factors)
  - 1%-3% upper limit for most Europe funds
- Application of swing factor:
  - Must be equally applied to all purchasing and redeeming shareholders (regardless of order size)
  - Applied to all share classes
- The board must approve any swing factor upper limit and any changes to the upper limit.
- Determination of swing factor can be delegated to persons (designated by the Board) responsible for administrating the swing pricing policies
  - Determination of swing factor should be reasonably segregated from the portfolio management function, but portfolio manager can provide inputs to be used to make such determination (but not how those inputs would be employed in the determination).
- Board is not required to approve each swing factor that is used to adjust the NAV.
  - The SEC acknowledged it would not be feasible for the Board to approve each swing factor given the short timeframe to determine the swing factor.

Swing Pricing Example

For the purposes of the example, assume that the NAV per share is $10 and the swing factor adjustment is 50 basis points (bps):

- Material net outflows exceed swing threshold:
  - NAV per share swings down by 50bps.
  - Publish a NAV per share of $9.95.
  - The redeeming shareholder receives fewer proceeds for their shares in issue to compensate the existing shareholders for the dilution being caused.

Swing Pricing Example

For the purposes of the example, assume that the NAV per share is $10 and the swing factor adjustment is 50 basis points (bps):

- Material net inflows exceed swing threshold:
  - NAV per share swings up by 50bps.
  - Publish a NAV per share of $10.05.
  - The shareholder trading on the day receives less shares in issue for their monetary investment to compensate existing shareholders for the dilution incurred on the fund.

Swing Pricing Questions

- Partial Swing Pricing vs. Dual Pricing vs. Full Swing Pricing
  - Use swing pricing for only net redemptions?
- Exempt certain shareholder transactions for Swing Pricing?
  - Small shareholder transactions
  - Shareholder purchasing on downward NAV adjustment days
- Swing Pricing vs. Purchase/Redemption Fees
  - Which category entails more burdens and costs
  - Which category is more feasible when shares are held primarily through third parties (i.e., operational challenges)
- Imposition of an SEC mandated upper limit on swing factor?
  - Different limits for different types of funds?
- Possible guidance from the SEC regarding the misapplication of a swing pricing policy re: when it does or does not result in a material NAV error.
  - Is this an "error" - a fund uses estimates under its swing pricing policy and applies those estimates correctly, but the estimates turn out to be materially incorrect.

Application of Swing Pricing to Certain Other Areas

- Performance reporting – use the NAV adjusted pursuant to its swing pricing policies.
- Performance fees - use the NAV adjusted pursuant to its swing pricing policies for calculating the performance fee.
- Merger of Funds – boards should consider whether they should temporarily suspend swing pricing ahead of a merger because of complications it may cause.
- Master Feeder Funds – swing pricing would generally only be appropriate for the level(s) of the fund structure that actually transacts in portfolio assets as a result of shareholder purchase/redemption activity.
- Financial Statements – disclose the NAV adjusted pursuant to its swing pricing policies and include the impact of swing pricing in its financial highlights.

Board Responsibility

- A fund's board, including the majority of its independent directors, would have to approve policies and procedures for swing pricing and any material changes to the policies and procedures.
  - This includes approval of the swing threshold (and any change thereto) and any swing factor upper limit.
- The board would appoint a fund's investment adviser or officers to administer the policies and procedures.
- The oversight requirement for the board is similar to the board's role for valuation issues.

NEW DISCLOSURE AND REPORTING OBLIGATIONS AND OTHER INFORMATION

Disclosure and Reporting Requirements

- N-1A: would be amended to require a fund to disclose information regarding the redemption of fund shares, and, if applicable, any use of swing pricing. A fund would also have to file any line of credit agreements and would have to reflect swing pricing in the financial highlights section.

- N-PORT: the former proposal would be amended to require a fund to report the liquidity classifications of its assets, and its three-day liquid asset minimum. A fund would also report if an asset is a 15% standard asset.

- N-CEN: the former proposal would be amended to require a fund to disclose information regarding committed lines of credit, interfund lending and swing pricing. An ETF must report if it required an authorized participant to post collateral to the ETF or any of its service provides in connection with the purchase or redemption of ETF shares.

Miscellaneous Topics

- Recordkeeping requirements
- Compliance dates

Recordkeeping Requirements

- Liquidity Risk Management Program
  - Copies of any policies and procedures effective during past five years.
  - Copies of any materials provided to the Board related to initial approval or material changes to the program.
  - Copies of written reports provided to the Board to review the adequacy and effectiveness of the program.
  - Records of any three day liquid asset minimum, or any adjustment thereto, were determined.
- Swing Pricing
  - Copies of any policies and procedures effective during past six years.
  - Records evidencing and supporting each computation of an adjustment to the NAV based on swing pricing.

Compliance Dates

- Liquidity Risk Management Program:
  - Larger entities - funds that together with other investment companies in the same "group of related investment companies" have net assets of $1 billion or more at the end of the most recent fiscal year:
    - 18 months
  - Smaller entities – funds that together with other investment companies in the same "group of related investment companies" have net assets of less than $1 billion at the end of the most recent fiscal year:
    - 30 months
- Swing Pricing:
  - Swing pricing is optional. No compliance period.
- Disclosure and Reporting:
  - Form N-1A: 6 months
  - Form N-PORT: large entities will be 18 months and small entities will be 30 months
  - Form N-CEN: 18 months

Biography

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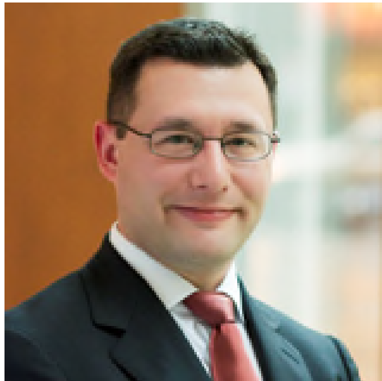
Sean Graber advises companies in the securities industry on investment management matters. Investment advisers, mutual funds, closed-end funds, private investment companies, registered funds of hedge funds, and exchange-traded funds seek his advice on organizational issues, registration, and ongoing regulatory compliance matters. He also serves as counsel to the boards of directors of mutual funds, and he advises insurance companies on regulatory matters relating to variable insurance products.

Biography



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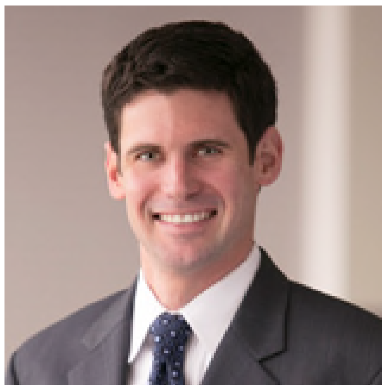
The investment management world is complex and highly regulated, and David W. Freese works closely with mutual funds, exchange-traded funds (ETFs), closed-end funds, private funds, and their investment advisers to navigate the shifting terrain. He brings particular experience in launching new fund complexes, from identifying legal issues that arise from proposed fund strategies, through initial US Securities and Exchange Commission (SEC) registration, organizational board of directors meetings, and fund seedings.



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Beau Yanoshik focuses his practice on the regulation of investment companies and investment advisers. He advises clients on forming and registering investment companies, including exchange-traded investment companies, and he provides ongoing advice regarding various regulatory compliance and securities law issues. Additionally, Beau counsels on transactional matters, including reorganizations, mergers, and acquisitions involving investment companies. He additionally assists with regulatory filings and in obtaining exemptive and no-action relief from various provisions of the Investment Company Act of 1940.

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