SEC Proposes Liquidity Management Rules for Open-End and Exchange-Traded Funds

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10/09/15

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On September 22, 2015, the Securities and Exchange Commission (SEC) voted to propose a new Rule 22e-4 under the Investment Company Act of 1940 (the 1940 Act), as well as amendments to its rules and forms designed to promote effective liquidity risk management for open-end funds (*i.e.*, mutual funds and exchange-traded funds, or ETFs). Additionally, the proposed amendments would allow open-end funds (other than money market funds and ETFs) to use "swing pricing" and would enhance disclosure regarding fund liquidity and redemption practices.

The SEC's proposals would (1) introduce a new Rule 22e-4 under the 1940 Act requiring registered open-end funds (including ETFs, but not including money market funds) to establish a liquidity risk management program, (2) amend Rule 22c-1 under the 1940 Act to permit, but not require, registered open-end funds (except for ETFs and money market funds) to use "swing pricing" and amend Rule 31a-2 to require funds to preserve certain records related to swing pricing, and (3) amend disclosure and reporting requirements on Form N-1A, proposed Form N-PORT and proposed Form N-CEN regarding swing pricing and liquidity risk management.[1]

Rule 22e-4: Liquidity Risk Management Programs

Open-end funds must allow investors to redeem their shares daily. As a result, funds must maintain sufficiently liquid assets to meet shareholder redemptions[2] while also minimizing the impact of those redemptions on the fund's remaining shareholders.

Under proposed Rule 22e-4, open-end funds (including ETFs, but not including money market funds) would be required to adopt a liquidity risk management program designed to assess and manage the fund's liquidity risk.[3] Proposed Rule 22e-4 defines "liquidity risk" 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."[4]

The elements of fund liquidity risk management programs would include:

Classification of the Liquidity of Fund Portfolio Assets. Funds would be required to assign a liquidity classification to their portfolio securities (or portions of such securities) and review such liquidity classifications on an ongoing basis.[5] The liquidity classification would be based on the number of days in which the fund could convert the asset into cash at a price that would not materially affect the value of that asset immediately prior to sale. The liquidity classifications are: one business day; 2-3 business days; 4-7 calendar days; 8-15 calendar days; 16-30 calendar days; and more than 30 calendar days.

[1] Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release, Investment Company Act Rel. No. 31835 (Sept. 22, 2015) (Proposing Release).

[2] Section 22(e) of the 1940 Act prohibits funds from suspending the right of redemption or postponing the date of payment of redemption proceeds for more than seven days after the tender of the security absent specified unusual circumstances. Rule 15c6-1 under the Securities Exchange Act of 1934, as amended (the Exchange Act), requires broker-dealers to settle securities transactions within three business days after the trade date. Thus, because a broker-dealer is often involved in the redemption process, as a practical matter many funds in fact meet redemption requests within three days in order to facilitate broker-dealer compliance with Rule 15c6-1. *See, e.g.*, Letter from Jack W. Murphy, associate director and chief counsel, Division of Investment Management, U.S. Securities and Exchange Commission, to Paul Schott Stevens, general counsel, Investment Company Institute (May 26, 1995).

[3] Proposing Release at 44.

[4] Proposing Release at 44-45 (referencing Proposed Rule 22e-4(a)(7)).

[5] Proposing Release at 61-62 (referencing Proposed Rule 22e-4(b)(2)(i)).

When determining the liquidity classification of an asset, funds would have to take into account the following factors, as applicable (the Liquidity Classification Factors):[6]

- Existence of an active market for the asset, including exchange listing and number, diversity and quality of market participants;
- Frequency of trades or quotes for the asset and average daily trading volume of the asset;
- Volatility of trading prices for the asset;
- Bid-ask spreads for the asset;
- Whether the asset has a relatively standardized and simple structure;
- Maturity and date of issue for fixed-income securities;
- Restrictions on trading and limitations on transfer of the asset;
- Size of the fund's position in the asset relative to the asset's average daily trading volume and, as applicable, the number of units of the asset outstanding; and
- Relationship of the asset to another portfolio asset.

Proposed Rule 22e-4 also would codify the SEC's long-standing policy[7] of limiting funds' investments in illiquid assets to 15% of net assets.[8] This codification is implemented by requiring that a 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."[9] 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 purposes of this definition, 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."[10] This is largely consistent with current SEC guidance related to, and industry interpretation of, this long-standing position. As a result, a security categorized as 8-15 calendar days, 16-30 calendar days, or more than 30 calendar days would not necessarily need to be treated as a 15% standard asset. However, it is notable that although this long-standing interpretation is retained, the SEC has proposed to add substantial new requirements regarding portfolio liquidity, including the liquidity classification requirements described above and the "three-day liquid asset minimum" described below, each of which comes with SEC-mandated factors to consider regarding that liquidity determination.

Assessment, Periodic Review and Management of a Fund's Liquidity Risk. Funds would be required to assess and periodically review their liquidity risk. This assessment and review would need to take into account the following specific factors, which are not meant to be exhaustive (the Liquidity Assessment Factors):

1. Short-term and long-term cash flow projections, taking into account the following considerations:
   - The 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; and
   - The degree of certainty associated with the fund's short-term and long-term cash flow projections;
2. Investment strategy and the liquidity of portfolio assets;
3. Use of borrowings and derivatives for investment purposes; and
4. Holdings of cash and cash equivalents, as well as borrowing arrangements and other funding sources.[11]

The SEC also has included guidance in the Proposing Release regarding each of the Liquidity Assessment Factors.[12] Regarding the periodic review aspect of this element of the proposed liquidity risk management program, the SEC states that "the proposed liquidity risk review requirement would permit each fund to develop and adopt effective and individualized procedures to review the fund's liquidity risk, tailored as appropriate to reflect the fund's particular facts and circumstances."[13] Beyond the factors enumerated above, however, the SEC's proposal does not prescribe any particular review procedures, nor does it specify the required risk review period or incorporate specific developments that a fund should consider as part of its review. While there are benefits to a flexible approach that allows funds to establish liquidity risk review procedures that are tailored to their particular circumstances, there is also the possibility that, without clearly prescribed minimum requirements, regulators may, in hindsight, find fault with funds' good faith efforts.

Establishment of a Three-Day Liquid Asset Minimum. Fund boards would be required to determine a "three-day liquid asset minimum" for their funds, which would be a minimum percentage of their 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

[6] Proposing Release at 80 (referencing Proposed Rule 22e-4(b)(2)(ii)).

[7] Revisions of Guidelines to Form N-1A, Investment Company Act Rel. No. 18612 (Mar. 12, 1992).

[8] Proposing Release at 152-155 (referencing Proposed Rule 22e-4(b)(2)(iv)(D)).

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

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

[11] Proposing Release at 108 (referencing Proposed Rule 22e-4(b)(2)(iii)).

[12] Proposing Release at 109-129.

[13] Proposing Release at 129.

prior to sale (defined as "three-day liquid assets").[14] In determining a three-day liquid asset minimum, fund boards would need to consider the Liquidity Assessment Factors described above.

Funds would be required to review the adequacy of the three-day liquid asset minimum at least semiannually considering the same factors. As explained by the SEC, "Because we anticipate that a fund would rely significantly on its three-day liquid assets in meeting fund redemptions, we view the three-day liquid asset minimum determination as a cornerstone of a fund's liquidity risk management, and we believe it is important for a fund to periodically reassess whether its three-day liquid asset minimum effectively assists the fund in managing its liquidity risk. We envision the determination of a fund's three-day liquid asset minimum as a dynamic process, incorporating new or updated information into the fund's assessment of factors, reflecting shareholder-related, fund-management-oriented, or market changes that could affect the fund's ability to meet redemptions."[15]

SEC Commissioner Michael S. Piwowar expressed concern about the three-day liquid asset minimum, noting that he preferred that the rule track Section 22(e) of the 1940 Act, which requires funds to make payment on redemptions within seven days, and he encouraged commenters to provide feedback on this issue.[16] The SEC reasons, however, that most funds sell at least some of their shares through broker-dealers and thus, as a practical matter, such funds in fact seek to meet redemptions within three business days in order to facilitate broker-dealer compliance with Rule 15c6-1 under the Exchange Act.[17] As explained above, Rule 15c6-1 establishes the "T+3" settlement cycle for most transactions involving a broker-dealer. Importantly, the proposal to require a three-day liquid asset minimum would convert this voluntary effort to facilitate a third party's ability to comply with its own regulatory requirements into a new primary regulatory obligation of a fund. Although the SEC did acknowledge that even though many funds voluntarily settle redemptions on the next business day (*i.e.*, T+1), it was "not proposing that funds maintain a minimum amount of assets that may be converted to cash within one day, given the impact such a minimum could have on investment strategies,"[18] the Rule 15c6-1 "T+3" rationale for the three-day liquid asset minimum could nevertheless prove very problematic should the SEC determine to act on industry recommendations to move to "T+2" settlement.[19]

Board Approval and Review. Each fund's board, including a majority of the fund's independent directors, would be required to approve the fund's liquidity risk management program, including the fund's three-day liquid asset minimum (and any material change to the liquidity risk management program, including a change to the fund's three-day liquid asset minimum).[20] The board also would be responsible for designating the fund's investment adviser or officers, which may not be solely the fund's portfolio managers, to administer the fund's liquidity risk management program.[21]

The fund's investment adviser must provide, and the board must review, an annual written report on the adequacy of the fund's liquidity risk management program, including the fund's three-day liquid asset minimum, and the effectiveness of its implementation.[22]

Recordkeeping. A fund would be required to maintain records relating to its liquidity risk management program, including: (1) a written copy of the policies and procedures adopted under the rule, (2) copies of board materials relating to the board's approval and review of the fund's liquidity risk management program, and (3) a written record of how the three-day liquid asset minimum, and any adjustments thereto, were determined, including assessment of the Liquidity Assessment Factors.[23]

Amendment to Rule 22c-1: Swing Pricing

The proposed amendment to Rule 22c-1 would permit open-end funds (except for money market funds and ETFs) to use "swing pricing" under certain circumstances.[24] Swing pricing is designed to protect existing shareholders from the dilution associated with shareholder purchases and redemptions by allowing funds to adjust their net asset values (NAVs) to reflect the costs associated with shareholders' trading activity. Notably, in proposing that U.S. mutual funds be permitted to implement swing pricing, the SEC

[14] Proposing Release at 130-131 (referencing Proposed Rule 22e-4(b)(2)(iv)(A)-(C)). Proposed Rule 22e-4(b)(2)(iv)(C) prohibits 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 "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." Proposed Rule 22e-4(a)(6). In determining whether an asset is a "less liquid asset" or a "three-day liquid asset," funds would be required to consider the Liquidity Classification Factors described above.

[15] Proposing Release at 145.

[16] Commissioner Michael S. Piwowar, "Statement at Open Meeting on Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release" (Sept. 22, 2015) at Section III.

[17] Proposing Release at 132-133.

[18] Proposing Release at 132-133.

[19] *See* "Shortening the Settlement Cycle: The Move to T+2"; Letter from Mary Jo White, chair, U.S. Securities and Exchange Commission, to Kenneth E. Bentsen, Jr., president & CEO, Securities Industry and Financial Markets Association, and Paul Schott Stevens, president & CEO, Investment Company Institute (Sept. 16, 2015) (expressing support for the industry's efforts to move to a T+2 settlement cycle), *available* here.

[20] Proposing Release at 175-176 (referencing Proposed Rule 22e-4(b)(3)(i)).

[21] Proposing Release at 177 (referencing Proposed Rule 22e-4(b)(3)(iii)).

[22] Proposing Release at 176 (referencing Proposed Rule 22e-4(b)(3)(ii)).

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

[24] Proposing Release at 190 (referencing Proposed Rule 22c-1(a)(3)).

looked to foreign funds' use of this concept, and in particular "a strong directional trend towards the adoption of swing pricing among major market participants in [Luxembourg], which is a significant jurisdiction for the organization of UCITS funds in Europe."[25]

Under the proposed rule, funds would be permitted, but not required, to adopt swing pricing policies and procedures that provide that the fund will adjust its NAV by an amount designated as the "swing factor" once the level of purchases or redemptions has exceeded a specified percentage of the fund's NAV, which would be known as the "swing threshold."[26] When a fund experiences net purchases exceeding the swing threshold, the fund would be able to adjust its NAV upward and effectively require purchasing shareholders to cover the costs of the fund investing additional portfolio assets. When a fund experiences net redemptions exceeding the swing threshold, the fund would be able to adjust its NAV downward and effectively require the redeeming shareholders to cover the costs of the fund selling portfolio assets. Effectively, the fund would set liquidity bands, and shareholders who trade in amounts outside these bands would incur additional costs.

A fund adopting swing pricing would be required to consider the following factors in determining the swing threshold that would be specified in the fund's swing pricing policies and procedures:[27]

- 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, and the fund's borrowing arrangements and other funding sources; and
- The costs associated with transactions in the markets in which the fund invests.

The fund would be required to review its swing threshold at least annually, considering the same factors.

The "swing factor" would be an amount, expressed as a percentage of the fund's NAV and determined pursuant to the fund's swing pricing procedures, by which a fund adjusts its NAV per share when the level of net purchases into or net redemptions from the fund has exceeded the fund's swing threshold. The fund's swing pricing policies and procedures would need to specify how the swing factor is to be determined and set forth any upper limit for it. The determination of the swing factor, as well as any upper limit, would need to 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 NAV per share, including any market impact costs, spread costs, transaction fees and charges 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 NAV per share, if that information would not be reflected in the current NAV of the fund computed that day.

A fund's board, including a majority of its independent directors, would be required to approve the fund's swing pricing policy and procedures (including the fund's swing threshold and any swing factor upper limit).[28] Material changes to a fund's swing pricing policies and procedures (including any change to the fund's swing threshold, a change to any swing factor upper limit specified under the fund's swing pricing policies and procedures, or any decision to suspend or terminate the fund's swing pricing policies and procedures) also would be subject to board approval. Further, 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 for determining the swing factor that would be used each time the swing threshold was breached. The determination of the swing factor would need to be reasonably segregated from the portfolio management function of the fund.

The SEC also has proposed to amend Rule 31a-2 under the 1940 Act to require records to be kept supporting each computation of an adjustment to the NAV of fund shares based on the fund's swing pricing policies and procedures.

Amendments to Registration and Reporting Forms

The SEC proposed amendments to the registration form used by open-end funds (Form N-1A) and two recently proposed reporting forms (Form N-PORT and Form N-CEN).[29] As a result of the proposed revisions to proposed Form N-PORT and proposed

[25] Proposing Release at 188 (citing Association of the Luxembourg Fund Industry, "Swing Pricing: Survey, Reports & Guidelines" (Feb. 2011)).

[26] Proposing Release at 192 (referencing Proposed Rule 22c-1(a)(3)(i)(A)).

[27] Proposing Release at 212-213 (referencing Proposed Rule 22c-1(a)(3)(i)(B)).

[28] Proposing Release at 230 (referencing Proposed Rule 22c-1(a)(3)(ii)(A).

[29] Form N-PORT and Form N-CEN were proposed in connection with the SEC's recent proposal to modernize investment company reporting. *See* "Investment Company Reporting Modernization, Investment Company Act Rel. No. 31610" (May 20, 2015) (the Investment Company Reporting Release). The proposals contained in the Investment Company Reporting Release are described in further detail in the July 30, 2015, Skadden client alert "The SEC Proposes Expanding Reporting Requirements for Investment Companies."

Form N-CEN, the SEC reopened the comment period for the Investment Company Reporting Release.

Form N-1A. The proposed amendments would require a fund to disclose its use of swing pricing,[30] the impact of swing pricing on the fund's NAV,[31] the number of days in which the fund will pay redemption proceeds to redeeming shareholders,[32] the methods and funding sources the fund uses to meet redemption requests,[33] and any agreements related to lines of credit.[34] Additionally, funds using swing pricing would be required to use their NAVs, as adjusted pursuant to their use of swing pricing, in reporting financial highlights and performance.[35]

Form N-PORT. The proposed amendments would require a fund to disclose the liquidity classification of the fund's portfolio securities based on the categories in proposed Rule 22e-4[36] and the fund's three-day liquid asset minimum.[37] These disclosures are in addition to the disclosure requirement proposed in the Investment Company Reporting Release that funds report whether an asset is a 15% standard asset.[38]

[30] Proposing Release at 254 (referencing Proposed Item 6(d) of Form N-1A).

[31] Proposing Release at 247 (referencing Proposed Item 13 of Form N-1A).

[32] Proposing Release at 251 (referencing Proposed Item 11(c)(7) of Form N-1A).

[33] Proposing Release at 252 (referencing Proposed Item 11(c)(8) of Form N-1A).

[34] Proposing Release at 253 (referencing Proposed Item 28(h) of Form N-1A).

[35] Proposing Release at 409-411 (proposing amendments to Items 13 and 26 of Form N-1A).

[36] Proposing Release at 258 (referencing Proposed Item C.13 of Proposed Form N-PORT).

[37] Proposing Release at 261-262 (referencing Proposed Item B.7 of Proposed Form N-PORT).

[38] Proposing Release at 261 (referencing Proposed Item C.7 of Proposed Form N-PORT).

Form N-CEN. The proposed amendments would require a fund to disclose information regarding committed lines of credit,[39] whether the fund engaged in interfund borrowing and lending,[40] and whether the fund engaged in swing pricing.[41] Additionally, an ETF would be required to report whether it required an authorized participant to post collateral to the ETF or any of its designated service providers in connection with the purchase or redemption of ETF shares.[42]

Conclusion

The Proposing Release is supported by a white paper prepared by the SEC's Division of Economic and Risk Analysis staff titled "Liquidity and Flows of U.S. Mutual Funds," which provides additional information regarding portfolio liquidity. The comment period for the Proposing Release and the reopened comment period for the Investment Company Reporting Release will be for 90 days after publication of the Proposing Release in the Federal Register (as of October 8, 2015, it had not been published). Skadden's Investment Management Group regularly assists clients in preparing comments to SEC rule proposals.

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[39] Proposing Release at 263-264 (referencing Proposed Item 44(a)(i)-(iii) of Part C of Proposed Form N-CEN).

[40] Proposing Release at 264 (referencing Proposed Item 44(b) and (c) of Part C of Proposed Form N-CEN).

[41] Proposing Release at 265 (referencing Proposed Item 44 of Proposed Form N-CEN).

[42] Proposing Release at 266 (referencing Proposed Item 60(g) of Proposed Form N-CEN).