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SEC Adopts Rules Addressing Liquidity Risk Management and "Swing Pricing" for Open-End Funds

New Rules and Amendments to Rules and Forms Require Most Open-End Funds to Implement Liquidity Risk Management Programs and Permit their Use of Swing Pricing

SUMMARY

On October 13, 2016, the Securities and Exchange Commission approved the adoption of two new rules and associated forms, and amendments to rules and forms, under the Investment Company Act of 1940 aimed at promoting effective liquidity risk management.[1] Among other things, the adopted rules and amendments will:

- require most registered open-end funds, including most ETFs but excluding money market funds, to develop and implement a liquidity risk management program and to classify the liquidity of each of their portfolio positions into one of four liquidity categories;
- require such funds to establish a minimum percentage of net assets to be invested in "highly liquid investments" (*i.e.*, assets that the fund believes could be converted to cash in current market conditions within three business days without significantly changing the market value of the investments) and adopt policies and procedures regarding any shortfall from the established minimum;
- Prohibit a fund from acquiring any illiquid investment if doing so would result in the fund holding more than 15% of its net assets in illiquid investments;
- allow, but not require, registered open-end funds other than money market funds and ETFs to use "swing pricing," a process of adjusting the net asset value of a fund's shares in order to pass the cost of trading in such shares to purchasing or redeeming shareholders;
- require new disclosure and reporting related to a fund's liquidity risk management program and swing pricing policies, including the reporting of any breach of the fund's established highly liquid investment minimum on new Form N-LIQUID; and
- require initial approval and periodic review of the liquidity risk management program and swing pricing policies by the fund's board of directors, including a majority of independent directors.

Funds in complexes with net assets of $1 billion or more will be required to comply with the rules pertaining to liquidity risk management by December 1, 2018, while other funds must comply by June 1, 2019.

BACKGROUND

The final rules adopt in two separate SEC releases issued simultaneously (the "Liquidity Risk Adopting Release" and the "Swing Pricing Adopting Release"), a modified version of proposed rules released for comment in a release dated September 22, 2015 (the "Proposing Release").

As acknowledged in the Proposing Release, the new liquidity rules respond in part to concerns raised by other regulators, including the Financial Stability Oversight Council ("FSOC"), regarding potential "systemic risks" in the asset management industry.[2] Because open-end funds are required under the Investment Company Act of 1940 (the "Investment Company Act") to redeem an investor's shares upon request within seven calendar days (and investors often expect to receive redemption proceeds in less than seven days), the failure to properly manage liquidity may result in a fund being unable to meet redemption requests in a timely manner, or being forced to sell illiquid assets at a significant discount in order to satisfy such requests, negatively affecting the fund's remaining investors. In remarks delivered at the meeting at which the final rules were adopted, SEC Chair Mary Jo White noted that recent trends in the asset management industry, including the rise of investment strategies that utilize securities tending to be less liquid, have exacerbated this risk and heightened the need for effective liquidity management by open-end funds,[3] observing in particular the recent suspension of investor redemptions and liquidation at the Third Avenue Focused Credit Fund.[4]

The proposed rules were aimed at promoting a stronger approach to liquidity risk management throughout the open-end fund industry, and the Liquidity Risk Adopting Release represents the second step in a comprehensive five-part plan announced by Chair White in December 2014 to modernize regulation of the asset management industry in order to address perceived risks arising from increasingly complex portfolios and investment practices.[5] Simultaneously with the adoption of the rules discussed herein, the SEC adopted new rules related to registered investment company reporting obligations.[6]

LIQUIDITY RISK MANAGEMENT PROGRAMS

Final rule 22e-4 under the Investment Company Act will require each registered open-end management investment company, including some open-end exchange-traded management investment companies ("ETFs") but not including money market funds, unit investment trusts ("UITs") or ETFs which meet redemption requests primarily through in-kind transfers ("In-Kind ETFs"), to adopt and implement a written liquidity risk management program ("LRMP") that is reasonably designed to assess and manage the fund's liquidity risk. "Liquidity risk" is defined in the rule as "the risk that a fund could not meet requests to redeem shares issued by the fund without significant dilution of remaining investors' interests in the fund."[7] This requirement extends to each separate series of a registered open-end management investment company, and for purposes of the discussion of rule 22e-4, each such registered open-end investment company or separate series thereof is referred to herein as a "fund."[8] While not obliged to establish liquidity risk management programs, UITs and In-Kind ETFs will be required to comply with certain components of rule 22e-4. The rule does not apply to closed-end funds.

As part of its LRMP, each fund will be required to (1) classify each of its portfolio positions (or portions thereof) based on a category system prescribed by the rule and review such classifications on at least a monthly basis, (2) assess and review at least annually the fund's overall liquidity risk, and (3) manage the fund's liquidity risk, including by identifying a minimum percentage of its net assets that must be invested in cash or in positions that could be converted into cash within three business days. Each of these requirements is discussed in greater detail below.

The LRMP must be administered by the fund's investment adviser or an officer or officers of the fund and may not be administered solely by portfolio managers of the fund. In addition, the fund's board of directors, including a majority of its independent directors, must approve the LRMP and review a written report provided by the administrator of the LRMP on at least an annual basis.

1. Classification of Liquidity of Portfolio Assets

As part of its LRMP, a fund will be required to classify each of the fund's portfolio positions (or portions thereof) based on its relative liquidity and engage in a regular review of such classifications. The classifications are based on the number of days in which a fund determines that it reasonably expects an investment to be convertible to cash (or, in the case of the less-liquid and illiquid categories, sold or disposed of) without the conversion significantly changing the market value of the investment,[9] and each fund position must be sorted into one of the following four categories:

- ***Highly liquid investments***, defined as cash and any investment reasonably expected to be convertible to cash in current market conditions in three business days or less without the conversion to cash significantly changing the market value of the investment;
- ***Moderately liquid investments***, defined as any investment reasonably expected to be convertible to cash in current market conditions in more than three calendar days, but in seven calendar days or less without the conversion to cash significantly changing the market value of the investment;
- ***Less liquid investments***, defined as any investment reasonably expected to be sold or disposed of in current market conditions in seven calendar days or less without the sale or disposition significantly changing the market value of the investment, but where the sale or disposition is reasonably expected to settle in more than seven calendar days; and
- ***Illiquid investments***, defined as any investment that may not reasonably be expected to be sold or disposed of in current market conditions in seven calendar days or less without the sale or disposition significantly changing the market value of the investment.[10]

Importantly, the final rule adopts a standard of "significantly changing" the price of an asset as opposed to "materially affecting" it, as originally proposed, in response to commenters' concerns regarding the opacity of a "materiality" standard and the potential for asset prices to move in response to their sale. In addition, the evaluation made regarding portfolio classification is to be considered under current, and not potentially stressed, market conditions, and funds will be required to review portfolio classifications at least monthly.[11] The four-category approach adopted in the final rules modifies the more granular six-category classification system initially proposed.

The final rule adopts a principles-based approach that requires that funds take into account generally relevant market, trading and investment-specific considerations, but does not contain a specific list of factors which must be considered in making liquidity classification determinations.[12] This approach modifies the rule as originally proposed, which had included nine factors funds were to be required to review. These nine factors are included as guidance in the Liquidity Risk Adopting Release; however, funds are not required to consider them.[13] This approach permits funds to assess the classification of particular portfolio positions on an asset class-wide basis, though funds must assess whether individual portfolio positions have investment-specific concerns by:

- considering whether the adviser has any information regarding any market, trading or investment-specific characteristic about a security that is reasonably expected to affect the liquidity profile, in which case the security must be evaluated separately from the broader asset class;
- determining whether trading varying portions of a position in a particular portfolio investment, in sizes that the fund would reasonably anticipate trading, is reasonably expected to significantly affect the liquidity characteristics of that investment; and
- for derivatives transactions that a fund has classified as moderately liquid investments, less liquid investments, and illiquid investments, identifying the percentage of its highly liquid investments that are segregated to cover, or pledged to satisfy margin requirements in connection with, derivatives transactions in each of these classification categories.[14]

The final rule also requires funds to file a revised Form N-PORT containing both the liquidity classification assigned to each of the fund's portfolio investments and the aggregate percentage of its portfolio investments that falls into each of the four liquidity classification categories discussed above.[15] The aggregated information will be publicly disclosed 60 days after the end of the fiscal quarter, while position-level classifications will be reported confidentially and will remain non-public.

2. Assessment and Review of Liquidity Risk

In addition to the requirement to classify each position by liquidity, rule 22e-4 requires each fund to assess and periodically review, at least annually, the fund's overall liquidity risk, taking into account a list of factors specified in the proposed rule as applicable to that fund. This represents a change from the approach of the rules as proposed, which required that funds consider each of the listed factors regardless of their applicability to the fund's particular circumstances. Factors to be taken into account in the fund's initial assessment of liquidity risk and subsequent periodic reviews include:

- investment strategy and the liquidity of portfolio assets during both normal and reasonably foreseeable stressed conditions, including (i) whether the investment strategy is appropriate for an open-end fund, (ii) the extent to which the strategy involves a relatively concentrated portfolio or large positions in particular issuers, and (iii) the use of borrowings for investment purposes and derivatives[16];

- short- and long-term cash flow projections during both normal and reasonably foreseeable stressed conditions[17];
- holdings of cash and cash equivalents, as well as borrowing arrangements and other funding sources; and
- for an ETF, (i) the relationship between the ETF's portfolio liquidity and the way in which, and the prices and spreads at which, the ETF's shares trade, including the efficiency of the arbitrage function and the level of active participation by market participants; and (ii) the effect of the composition of baskets on the overall liquidity of the ETF's portfolio."[18]

The SEC noted in the Liquidity Risk Adopting Release that this list of factors is not intended to be exhaustive, and that funds may take into account other considerations in addition to those specifically provided in the proposed rule.[19] Moreover, the SEC sought to simplify certain evaluative factors in the final rule in order to avoid an "overly complex liquidity risk assessment analysis," which risks becoming a generic checklist, to the detriment of investors.[20]

3. Management of Liquidity Risk

The final rule requires funds to manage liquidity risk by (1) establishing a "highly liquid investment minimum" and abiding by such minimum, (2) not acquiring any illiquid investment in excess of a 15% limit and (3) establishing policies and procedures regarding redemptions in-kind, to the extent the fund engages in or reserves the right to engage in redemptions in-kind.

a. Highly Liquid Investment Minimum

Under the final rule, any fund that does not hold primarily highly liquid investments is required to determine a "highly liquid investment minimum," *i.e.*, a minimum percentage of net assets to be invested in assets that the fund reasonably expects to be convertible to cash in three business days or less without the conversion to cash significantly changing the market value of the investment ("highly liquid investments").[21]

In determining its highly liquid investment minimum, each fund will be required to consider the same factors required to be considered in connection with the fund's assessment and periodic reviews of liquidity risk (such as short- and long-term cash flow projections), though (i) only as applicable to that particular fund, and (ii) only with respect to current conditions and reasonably foreseeable stressed conditions which may arise before the next evaluation period. In addition, a fund will be required to review its highly liquid investment minimum at least annually

Funds will not be prohibited from acquiring any non-highly liquid investments if, immediately after such acquisition, the fund would have less than its highly liquid investment minimum invested in highly liquid assets, as had been originally proposed.[22] However, funds will be required to implement policies and procedures for responding to a shortfall of the fund's holdings of highly liquid investments below the established minimum. Thus, a drop in the fund's percentage of net assets invested in highly liquid investments below the highly liquid investments minimum would not immediately prevent the fund from acquiring any non-highly liquid investments, nor would it force funds to liquidate less liquid assets in order to raise the percentage of assets invested in three-day liquid assets up to the minimum.

In the event of such a shortfall, the fund will be required to report to its board of directors no later than the board's next regularly scheduled meeting with a brief explanation of the causes of the shortfall, the extent of the shortfall and any actions taken in response. If a shortfall lasts more than seven consecutive calendar days, the person(s) administering the highly liquid investment minimum program must report to the fund's board of directors within one business day thereafter with an explanation of how the fund plans to restore its minimum within a reasonable period of time.[23] The Liquidity Risk Adopting Release noted that this process will foster discussion between a fund and its board of directors on how to determine and maintain an appropriate highly liquid investment minimum target.[24]

As discussed below, each fund will be required to report its highly liquid investment minimum on a monthly basis on Form N-PORT. However, only information reported on Form N-PORT for the fund's fiscal quarter ends will be publicly available, and not until 60 days after the end of such fiscal quarter ends.

b. 15% Illiquid Investment Limitation

Rule 22e-4 replaces existing SEC guidance restricting funds from investing more than 15% of their net assets in illiquid investments.[25] In its place, the final rule prohibits a fund (including an In-Kind ETF but excluding a UIT or money market mutual fund) from acquiring any illiquid investment if, immediately after the acquisition, the fund would have invested more than 15% of its net assets in illiquid investments that are assets.[26] By harmonizing the 15% illiquid investment limitation with the definitions implemented in connection with the liquidity classification described above, the final rule modifies the rules as proposed, which included a new category of "15% standard assets" that did not conform with the liquidity classifications as proposed. As with the highly liquid investment minimum, the 15% illiquid investment limit provision would not require a fund to proactively sell illiquid positions if such assets account for more than 15% of the fund's net assets.

However, the Liquidity Risk Adopting Release emphasizes that a fund should not be permitted to exceed the 15% limit on illiquid investments for an extended period of time without board oversight.[27] To that end, if a fund breaches the 15% threshold, it must notify its board of directors within one business day and provide an explanation of the extent and causes of the occurrence and how the fund plans to bring its illiquid investments that are assets to or below 15% of net assets within a reasonable period of time.[28] Moreover, if a fund's breach of the 15% limit of illiquid investments continues for 30 days from the occurrence (and at each consecutive 30-day period thereafter), the fund's board of directors, including a majority of independent directors, must assess whether the plan presented to it, as previously described, continues to be in the best interest of the fund.[29] The Liquidity Risk Adopting Release acknowledged the burden this will have on fund boards, but observed that such a requirement is necessary given the potentially serious consequences arising from breaches of the 15% limitation.

In addition, the Liquidity Risk Adopting Release introduces a new form, Form N-LIQUID, on which funds will report information related to their compliance with the 15% illiquid investment minimum. In particular, a fund will be required to notify the SEC on Form N-LIQUID when (i) more than 15% of the fund's net assets are, or become, illiquid investments, (ii) the fund's illiquid investments that are assets previously exceeded 15% of net assets and the fund determines that its illiquid investments that are assets have changed to be less than or equal to 15% of net assets, or (iii) the fund's holdings in highly liquid investments that are assets fall below the fund's highly liquid investment minimum for more than seven consecutive calendar days.[30]

c. Policies and Procedures Regarding Redemptions In-Kind

The Liquidity Risk Adopting Release notes that many mutual funds reserve the right to redeem their shares in-kind rather than in cash and that such policies may function as a tool for managing liquidity risk under certain circumstances. Given the potential role of in-kind distributions in a fund's management of liquidity risk, the rule requires that funds that engage in, or reserve the right to engage in, redemptions in-kind adopt and implement written policies and procedures regarding, among other things, the process and circumstances for such in-kind redemptions.[31] The Liquidity Risk Adopting Release notes that effective policies adopted pursuant to this rule will contemplate a variety of circumstances and issues arising in connection with a fund's redemptions in-kind, including the fund's plan to use in-kind redemptions in normal and stressed conditions, any different redemption procedures for retail and institutional investors and whether the fund would redeem securities in a *pro rata* or non-*pro rata* manner.[32]

4. Board and Independent Director Approval

The Liquidity Risk Adopting Release emphasizes the "oversight role" played by a fund's board of directors in overseeing fund operations, particularly in areas presenting potential conflicts of interest between the fund and its investment adviser. In response to a variety of comments submitted, the final rules modified language originally proposed by more narrowly limiting the operational oversight required of fund boards and is intended to make clear that any new duties imposed on boards of directors by the final rule are consistent with their oversight role.[33]

Under the final rule, a fund's board of directors would be required to approve and oversee the operation of the fund's LRMP. In response to comments to the proposed rule, the final rule eliminates certain of the more specific and detailed approval requirements,[34] although the final rule nevertheless requires a fund's board, including a majority of its independent directors, to:

- approve the adoption of its initial LRMP;
- review, no less frequently than annually, a written report by the person(s) designated to administer the LRMP assessing its adequacy and effectiveness, including the operation of the highly liquid investment minimum and any material changes thereto; and
- approve the fund's designation of the fund's investment adviser or officers (which may not be solely portfolio managers of the fund) as responsible for administering the policies and procedures under the LRMP.[35]

In addition, a fund must seek board approval, including by a majority of independent directors, in the event it intends to change its previously determined highly liquid investment minimum at a time when the fund's assets that are highly liquid investments are below the determined minimum. And, as described above, a fund board must be informed within one business day if the fund's holdings of illiquid investments exceed 15% of its net assets. However, fund boards need not specifically approve a fund's highly liquid investment minimum or approve material changes to the LRMP, as had been required by the rule as proposed.

5. Recordkeeping Requirements

The final rule requires a fund to keep certain records pertaining to its LRMP, including in particular:

- a written copy of the policies and procedures adopted as part of the fund's liquidity risk management program for five years, in an easily accessible place;
- copies of any materials provided to the fund's board in connection with the board's initial approval of the fund's liquidity risk management program, and copies of written reports provided to the board on the adequacy of the fund's liquidity risk management program, including the fund's highly liquid investment minimum, and the effectiveness of its implementation for at least five years after the end of the fiscal year in which the documents were provided to the board, the first two years in an easily accessible place; and
- a written record of how its highly liquid investment minimum, and any adjustments thereto, were determined, including the fund's assessment and periodic review of its liquidity risk for a period of not less than five years, the first two years in an easily accessible place, following the determination of, and each change to, the fund's highly liquid investment minimum.[36]

6. Applicability to ETFs and UITs

The final rule adopts specially tailored requirements for ETFs and UITs. In particular all ETFs will be required to limit illiquid investments to 15% of their net assets and obtain board approvals regarding their compliance with this requirement. However, In-Kind ETFs will not be required to conduct the portfolio classifications or to adopt and monitor a highly liquid investment minimum. ETFs other than In-Kind ETFs will, however, be subject to both the portfolio classifications and the highly liquid investment minimum requirements.[37] In addition, the final rule provides that all ETFs must assess, manage, and periodically review their liquidity risk and needs, taking into account, as applicable, the liquidity risk factors for all funds as well as factors listed specifically relating to ETFs.[38]

Unit investment trusts are not subject to the major provisions of the final rule. However, in a change to the rule as proposed, each UIT's principal underwriter or depositor will be required to determine, on or before the date of the initial deposit of portfolio securities into the UIT, that the portion of illiquid investments that the UIT holds or will hold at the date of deposit that are assets is consistent with the redeemable nature of the securities it issues."[39] This provision serves a corollary to the rule's requirement that open-end funds examine whether a particular investment strategy is appropriate in the open-end fund context.

SWING PRICING

As part of its broad-based review of investment company liquidity issues and potential new ways to mitigate those issues, the SEC considered the "swing pricing" mechanism of pricing fund redemptions, which has been implemented in various foreign jurisdictions. Currently, Rule 22c-1 under the Investment Company Act (the "forward pricing" rule) requires funds, their principal underwriters, dealers in fund shares and other persons designated in a fund's prospectus, to sell or redeem fund shares based on the net asset value ("NAV") per share next computed following receipt of the purchase or redemption order, which is generally the NAV calculated as of 4:00 p.m. Eastern Time. However, changes in the fund's holdings of portfolio assets and in the number of outstanding shares are typically not reflected in the fund's NAV until the first business day following the fund's receipt of the shareholder's purchase or redemption request. Due to this delay, the price paid by a purchasing shareholder or received by a redeeming shareholder will generally not fully reflect the transaction costs incurred by the fund in order to meet the purchase or redemption request. Rather, such costs are borne by the fund's existing or non-redeeming shareholders.[40] In the case of redemptions, such costs are likely to be more significant in times of fund or market-wide liquidity stress, as funds may be required to liquidate assets within a short time period at significant discounts in order to meet their redemption obligations. Similarly, in the case of purchases of fund shares, periods of low market liquidity may result in the fund incurring significant market impact costs as it seeks to invest the proceeds of such purchases.

The SEC adopted amendments to rule 22c-1 under the Investment Company Act to permit, but not require, each registered open-end investment management company (other than any ETF or money market fund) to establish and implement policies and procedures that would require the fund to adjust its current NAV under certain circumstances to mitigate dilution of the value of its outstanding shares as a result of shareholder purchase and redemption activity, a process referred to as "swing pricing." ETFs, money market funds and unit investment trusts will not be permitted to use swing pricing. If a fund chooses to implement swing pricing, its swing pricing policies and procedures will be required to:

- provide that whenever the level of net purchases into or net redemptions from the fund exceed a specified "swing threshold(s)," the fund will adjust its NAV by a specified "swing factor(s)" (each expressed as a percentage of the fund's NAV), provided that the person(s) responsible for administering swing pricing shall make such a determination based on a reasonable estimate made in high confidence regarding the net purchases or redemptions of the fund[41];
- specify how the fund's swing threshold shall be determined, considering (1) the size, frequency and volatility of historical net purchases or net redemptions of fund shares during normal and stressed periods, (2) 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 (3) the costs associated with transactions in the markets in which the fund invests[42];
- specify how the swing factor will be determined, and the upper limit on the swing factor, which may not exceed two percent of NAV per share, taking into account only any near-term costs expected to be incurred by the fund as a result of net purchases or redemptions that occur on the day the swing factor is being applied, including 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 include the determination that the swing factor(s) used are reasonable in relationship to the fund's costs in meeting net shareholder subscriptions and redemptions; and
- provide for the periodic review by the fund's board, no less frequently than annually, of a written report prepared by the person(s) responsible for administering the fund's swing pricing program.[43]

The final swing pricing rules differ from the proposed rules in several respects. The final rule imposes a ceiling on a fund's swing factor at two percent of NAV per share and the SEC made it clear that, despite the absence of any formal floor for a fund's swing threshold in the rule, it would not be consistent with the rules for a fund to adopt a swing threshold of zero.[44] In addition, the final rule eliminated the proposed requirement that funds consider market impact costs and changes in the value of assets purchased or sold as a result of net purchases or redemptions in determining the swing factor. The SEC also notes that a fund with multiple share classes may not selectively swing the NAV of certain share classes but not others, noting that this would be inconsistent with rule 18f-3 since it would have the effect of having one share class pay transaction expenses incurred in the management of the fund's portfolio as a whole.

Under the final rule, a fund which chooses to implement a swing pricing program will need to develop commercial and operational practices which allow the fund to obtain reasonable estimates of daily investor flows for purposes of "reasonably estimating with high confidence" whether the fund will have crossed the swing threshold on any particular day. The Swing Pricing Adopting Release acknowledges that many current systems for processing fund orders do not permit the timely collection of this data in advance of the time at which funds typically strike their NAV for a given day. However, the SEC stated its belief that the industry will develop new systems and protocols in the two-year period preceding the rule's compliance date which will allow such information to be collected in a timely manner.[45]

The adoption by a fund of swing pricing policies and procedures, including the fund's swing threshold(s) and the upper limit on the swing factor(s) (as well as any changes thereto), will be subject to approval by the fund's board of directors, including a majority of the independent directors. In addition, the board of a fund that implements swing pricing will be required to designate the party responsible for administering the swing pricing policies and for determining the swing factor that will be used each time the swing threshold is breached, which may be the fund's investment adviser or a fund officer (provided that determination of the swing factor would be required to be "reasonably segregated" from the fund's portfolio management function), and to review no less frequently than annually a written report prepared by the designated party.[46] Importantly, in response to comments, fund boards will not be required to approve material changes to swing pricing policies and procedures generally, as was required in the proposed rule. The Swing Pricing Adopting Release states that the board's approval of the swing threshold and upper limit on the swing factor, and any changes thereto, is an important part of the board's oversight role, consistent with its obligations related to valuation and pricing related matters, and, while the fund's adviser is best suited to operate swing pricing policies, board oversight is essential to an effective swing pricing program which protects fund shareholders' interests.[47]

The SEC also adopted amendments to rule 22c-1 to require a fund to maintain a written copy of its swing pricing policies and procedures as in effect, or as in effect at any time in the past six years, as well as a written copy of the reports provided to the fund's board (as described above) for the past six years. In addition, rule 31a-2, which requires a fund to maintain records of each NAV calculation, has been expanded to require a fund to maintain records evidencing and supporting each calculation of an adjustment to NAV based on the fund's swing pricing policies. Finally, Form N-1A was amended to require disclosure of the fund's NAV reflecting any adjustments due to "swinging" as a separate item from its NAV computed in accordance with generally accepted accounting principles, in addition to requiring a general description of the effects of swing pricing on the fund's financial statements.[48] In addition, the final rules will require a fund to disclose its swing factor upper limit in Form N-1A and Form N-CEN.

Funds will be permitted to institute swing pricing pursuant to the rules two years after the publication of the rule in the Federal Register.

DISCLOSURE AND REPORTING REQUIREMENTS

The SEC also adopted amendments to Form N-1A, and adopted new Form N-PORT, Form N-CEN, and Form N-LIQUID to require additional disclosure and reporting by open-end funds regarding the liquidity of their portfolio assets and their liquidity risk management practices.[49] The new requirements are designed to improve the ability of investors, the SEC staff and other potential users to analyze and understand a fund's redemption practices, liquidity risk management and how liquidity risk management can affect shareholder redemptions. In addition, Form N-CEN, and amendments to Form N-1A and Regulation S-X, require certain disclosures regarding a fund's use of swing pricing.

1. Form N-1A and Regulation S-X

Form N-1A, as amended, requires open-end management investment companies, including money market funds and ETFs, to disclose the number of days in which they will pay redemption proceeds to investors. Moreover, such a fund must also disclose the methods used by the fund—under both normal and stressed market conditions—to meet redemption requests, including by selling portfolio assets, holding cash, providing in-kind redemptions or utilizing some form of borrowing.

A fund that elects to adopt swing pricing procedures must provide disclosures in its prospectus concerning the circumstances under which swing pricing would be used and the effects thereof. In addition, such funds will be required to discuss the impact of swing pricing in the notes to their financial statements. Funds must comply with the amendments to Form N-1A by June 1, 2017 and with amendments to Regulation S-X simultaneous with the adoption by a fund of a swing pricing program.

2. Form N-LIQUID

As discussed above, a fund must file confidential reports with the SEC on new Form N-LIQUID to report certain changes to its liquidity profile. In particular, a fund is required to notify the SEC when: (i) more than 15% of the fund's net assets are, or become, illiquid investments that are assets as defined in rule 22e-4, (ii) the fund's illiquid investments that are assets previously exceeded 15% of net assets and the fund determines that its illiquid investments that are assets have changed to be less than or equal to 15% of net assets, or (iii) the fund's holdings in highly liquid investments that are assets fall below the fund's highly liquid investment minimum for more than seven consecutive calendar days.[50]

Funds in complexes with net assets of $1 billion or greater must comply with the amendments to Form N-LIQUID by December 1, 2018, while other funds must comply by June 1, 2019.

3. Form N-PORT

Form N-PORT requires detailed reporting regarding fund liquidity risk management. In particular, a fund will be required to report for the end of each fiscal quarter, to be publicly published with a 60-day delay, the aggregate average percentage of its portfolio representing each of the four classification categories outlined in rule 22e-4 and information regarding the fund's highly liquid investment minimum (including current target, the number of days the fund failed to achieve its target in the relevant reporting period and any changes to the target minimum). Position level classifications must also be disclosed to the SEC, but will not be publicly released. In addition, a fund must publicly report the percentage of highly liquid investments that it has segregated to cover, or pledged to satisfy margin requirements in connection with, derivatives transactions that are classified as moderately liquid, less liquid, or illiquid investments.[51]

Funds in complexes with net assets of $1 billion or greater must comply with the amendments to Form N-PORT by December 1, 2018, while other funds must comply by June 1, 2019.

4. Form N-CEN

Form N-CEN will require further disclosure regarding certain liquidity risk management practices that the SEC expects will be used on a less frequent basis than the day-to-day liquidity risk tools captured by

Form N-PORT. In particular, a fund will report information regarding any lines of credit maintained by the fund, any inter-fund borrowing or lending activities of the fund and whether the fund has engaged in swing pricing during the reporting period. In addition, a fund must report whether it is an In-Kind ETF, and an ETF will 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 during the reporting period.

Funds in complexes with net assets of $1 billion or greater must comply with the amendments to Form N-CEN by December 1, 2018, while other funds must comply by June 1, 2019.

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ENDNOTES

1 *See* "Investment Company Liquidity Risk Management Programs" (October 13, 2016), *available at* https://www.sec.gov/rules/final/2016/33-10233.pdf (the "Liquidity Risk Adopting Release") and "Investment Company Swing Pricing" (October 13, 2016), *available at* https://www.sec.gov/rules/final/2016/33-10234.pdf (the "Swing Pricing Adopting Release"). These final rules were originally proposed in the "Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release, Securities Act Release No. 9922" (September 22, 2015), *available at* http://www.sec.gov/rules/proposed/2015/33-9922.pdf (the "Proposing Release"). For a discussion of the Proposing Release, *see* our firm memorandum "SEC Issues Liquidity Risk Management and 'Swing Pricing' Proposal for Open-End Investment Funds" (Oct. 2, 2015), *available at* *http://www.sullcrom.com/siteFiles/Publications/SC_Publication_SEC_Issues_Liquidity_Risk_Management_and_Swing_Pricing_Proposal_for_Open_End_Investment_Funds.pdf*. The Liquidity Risk Adopting Release and associated rule, form and amendments to rules and forms was adopted unanimously, while the Swing Pricing Adopting Release and associated rule, form and amendments to rules and forms was adopted by a vote of 2-1, with Commissioner Piwowar dissenting due to concerns about the sufficiency of investor protections included in the swing pricing rules as adopted.

2 *See* "Notice Seeking Comment on Asset Management Products and Activities," 79 FR 77488 (Dec. 24, 2014), *available at* http://www.gpo.gov/fdsys/pkg/FR-2014-12-24/pdf/2014-30255.pdf. For additional information regarding FSOC's scrutiny of the asset management industry, *see* our firm memorandum "Asset Management and Financial Stability" (Oct. 3, 2013), *available at* https://sullcrom.com/siteFiles/Publications/SC_Publication_Asset_Management_and_Financial_Stability.pdf.

3 White, Mary Jo. "Statement at Open Meeting: Modernizing and Enhancing Investment Company and Investment Adviser Reporting" October 13, 2016, *available at* https://www.sec.gov/news/statement/white-statement-open-meeting-101316.html.

4 The Swing Pricing Adopting Release contains over 20 references to the liquidity and other issues of the Third Avenue Focused Credit Fund, which was forced to suspend redemptions and pursue a liquidation process.

5 *See* "SEC Proposes Rules to Modify Reporting Regime for Registered Investment Companies and Investment Advisers" (May 26, 2015) *available at* http://sullcrom.com/sec-proposes-rules-to-modify-reporting-regime-for-registered-investment-companies-and-investment-advisers. Proposed rules relating to the "Use of Derivatives by Registered Investment Companies and Business Development Companies" were released on December 11, 2015, and are *available at* https://www.sec.gov/rules/proposed/2015/ic-31933.pdf. These are also part of the five-part plan to modernize regulation of the asset management industry.

6 For more information regarding the forms, please refer to our firm memorandum "SEC Modifies Reporting Regime for Registered Investment Companies" (Oct. 26, 2016), *available at* *https://www.sullcrom.com/sec-modifies-reporting-regime-for-registered-investment-companies.*

7 *See* rule 22e-4(a)(11).

8 *See* rule 22e-4(a)(5).

9 *See* pages 95 and 105 of the Liquidity Risk Adopting Release.

10 *See* rule 22e-4(a).

11 *See* page 105 of the Liquidity Risk Adopting Release.

12 *See* page 100 of the Liquidity Risk Adopting Release.

13 The SEC recommends, but does not require, that funds consider the nine factors as applicable. *See* pages 160-174 of the Liquidity Risk Adopting Release. The factors are:

- 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 for the asset and average daily trading volume of the asset (regardless of whether the asset is a security traded on an exchange);
- volatility of trading prices for the asset;
- bid-ask spreads for the asset;
- whether the asset has a relatively standardized and simple structure;
- for fixed-income securities, maturity and date of issue;
- restrictions on trading of the asset and limitations on transfer of the asset;
- the size of the fund's position in the asset relative to the asset's average daily trading volume and, as applicable, the number of units of the asset outstanding; and
- relationship of the asset to another portfolio asset.

14 *See* rule 22e-4(b)(1)(ii)(A)-(C). This final inquiry would implicate any assets segregated pursuant to "Securities Trading Practices of Registered Investment Companies, Investment Company Act Release No. 10666" (Apr. 18, 1979) ("Release 10666"). Moreover, this modifies the approach originally proposed, which would have required funds to consider the relationship of a particular asset to another in assessing its classification.

15 *See* page 179 of the Liquidity Risk Adopting Release.

16 *See* page 72 of the Liquidity Risk Adopting Release. Importantly, this adds a new requirement to the rule as originally proposed (that funds consider whether their investment strategy is appropriate for an open-end fund).

17 The Liquidity Risk Adopting Release discusses the following five factors as appropriate to consider, though not obligatory, when undertaking this inquiry: 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, the fund's distribution channels and the degree of certainty associated with the fund's short-term and long-term cash flow projections. *See* Liquidity Risk Adopting Release at pages 76-80.

18 Rule 22e-4(a)(14)(D)(i)-(ii).

19 *See* page 79 of the Liquidity Risk Adopting Release.

20 *Id.*

21 Rule 22e-4(b)(iii). The determination of whether a position in a portfolio asset is a "highly liquid investment" will be required to be based on the same factors used in determining the position's liquidity classification for purposes of rule 22e-4(b)(ii).

22 *See* page 217 of the Liquidity Risk Adopting Release.

23 Rule 22e-4(b)(iii)(3).

24 *See* page 217 of the Liquidity Risk Adopting Release.

25 *See* pages 126-127 of the Liquidity Risk Adopting Release.

26 Rule 22e-4(b)(1)(iv).

27 *See* page 236 of the Liquidity Risk Adopting Release.

ENDNOTES (CONTINUED)

[28] Rule 22e-4(b)(1)(iv)(A).

[29] *See* page 238 of the Liquidity Risk Adopting Release.

[30] *See* Part A and Part B of Form N-LIQUID provided in the Liquidity Risk Adopting Release at pages 454-455; *see also* pages 283-284.

[31] Rule 22e-4(b)(v).

[32] *See* pages 241-242 of the Liquidity Risk Adopting Release.

[33] *See* pages 250-251 of the Liquidity Risk Adopting Release.

[34] *See* page 256 of the Liquidity Risk Adopting Release.

[35] A fund must seek board approval, including by a majority of the independent directors, in the event it intends to change its previously determined highly liquid investment minimum at a time when the fund's assets that are highly liquid investments are below the determined minimum. Moreover, as described above, a fund board must be informed within one business day if the fund's holdings of illiquid investments exceed 15% of its net assets.

[36] *See* rule 22e-4(b)(3).

[37] *See* pages 260-261 of the Liquidity Risk Adopting Release.

[38] Rule 22e-4(a)(14)(D)(i)-(ii). The ETF specific factor mentioned is "the relationship between the ETF's portfolio liquidity and the way in which, and the prices and spreads at which, ETF shares trade, including the efficiency of the arbitrage function and the level of active participation by market participants (including authorized participants); and the effect of the composition of baskets on the overall liquidity of the ETF's portfolio."

[39] Rule 22e-4(c).

[40] *See* generally 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.

[41] *See* page 56 of the Swing Pricing Adopting Release and Rule 22c-1(a)(3)(i)(A). Any adjustment to the fund's NAV resulting from application of the swing factor would affect all purchasing and redeeming shareholders equally. Thus, in the event of a downward adjustment to NAV resulting from net redemptions exceeding the swing threshold, investors purchasing shares that day would pay a lower price than they would in the absence of swing pricing. Similarly, in the event of an upward adjustment to NAV due to net purchases exceeding the swing threshold, redeeming shareholders that day would receive a higher price for their shares than they would absent such adjustment.

[42] Under the final rule, a fund will not be required to publicly disclose its swing threshold. *See* page 39 of the Swing Pricing Adopting Release. The Proposing Release had asked for comment on whether such disclosure should be required, and the SEC concluded that the potential for shareholder "gaming" of swing pricing policies justified a no-disclosure approach.

[43] This report must include descriptions of: (i) the swing pricing administrator's review of the adequacy of the fund's swing pricing policies and procedures and the effectiveness of their implementation, including the impact on mitigating dilution, (ii) any material changes to the fund's swing pricing policies and procedures since the last report, and (iii) the process used by the fund to determine the fund's swing threshold(s), swing factor(s), and swing factor upper limit, including a review and assessment of information and data supporting these determinations. *See* pages 89-90 of the Swing Pricing Adopting Release and Rule 22c-1(a)(3)(ii)(D).

[44] *See* pages 45-46 of the Swing Pricing Adopting Release.

[45] *See* pages 30-32 of the Swing Pricing Adopting Release.

ENDNOTES (CONTINUED)

46 Rule 22c-1(a)(3)(ii)(C).

47 *See* pages 48, 82-86 of the Swing Pricing Adopting Release.

48 A fund that has implemented swing pricing will not be required to disclose its swing pricing threshold or swing factor in its prospectus or on Form N-1A. However, such a fund will be required to disclose the swing factor upper limit on Form N-1A and Form N-CEN. *See* pages 82 and 114 of the Swing Pricing Adopting Release.

49 *Supra* note 6.

50 *See* Part A and Part B of Form N-LIQUID, provided in the Liquidity Risk Adopting Release at pages 454-455; *see also* pages 283-284.

51 *See* Item B.8.a. of Form N-PORT.

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