October 2, 2015

SEC Issues Liquidity Risk Management and "Swing Pricing" Proposal for Open-End Investment Funds

Proposed Rule and Amendments to Rules and Forms Would Require Open-End Funds to Implement Liquidity Risk Management Programs and Permit Their Use of Swing Pricing

SUMMARY

On September 22, 2015, the Securities and Exchange Commission unanimously proposed a new rule and amendments to rules and forms under the Investment Company Act of 1940 aimed at promoting effective liquidity risk management by most registered open-end management investment companies.[1] Among other things, the proposed rules and amendments would:

- require registered open-end funds, including mutual funds and most ETFs but excluding money market funds, unit investment trusts and closed-end funds, to develop and implement a liquidity risk management program and to categorize the liquidity of each of their portfolio positions;
- require such funds to establish a minimum percentage of net assets to be invested in "three-day liquid assets" (*i.e.*, assets that the fund believes could be converted to cash within three business days at a price that does not materially affect the value of the asset immediately prior to sale), and prohibit funds from acquiring any less liquid asset if doing so would result in the fund having less than such minimum percentage invested in three-day liquid assets;
- 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; 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.

Comments on the SEC's proposed rules must be submitted no later than 90 days following publication in the Federal Register.

BACKGROUND

In remarks delivered at an SEC meeting to discuss the proposed rules, Chair Mary Jo White emphasized the importance of effective liquidity management to open-end investment companies. 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 typically 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. Chair White noted that modern developments in the asset management industry, including the rise of investment strategies that utilize securities that tend to be less liquid (including by high-yield bond funds, emerging market equity and debt funds and alternative strategy funds), have exacerbated this risk[2] and heightened the need for effective liquidity management by open-end funds. The proposed rules are aimed at promoting a stronger approach to liquidity risk management throughout the open-end fund industry, and represent the second step in a comprehensive five-part plan announced by Chair White last December to modernize regulation of the asset management industry in order to address perceived risks arising from increasingly complex portfolios and investment practices.[3]

The proposing release notes that in December 2014, the Financial Stability Oversight Council ("FSOC") issued a notice requesting comments on aspects of the investment management industry, including potential risks related to liquidity and redemptions,[4] and that while the proposed rules are primarily aimed at mitigating the adverse effects of liquidity risk on investors and on the fair, efficient and orderly operation of the securities markets, they may also have beneficial effects on financial stability.

LIQUIDITY RISK MANAGEMENT PROGRAMS

Proposed rule 22e-4 under the Investment Company Act would require each registered open-end management investment company, including open-end exchange-traded funds ("ETFs") but not including money market funds, to adopt and implement a written liquidity risk management program ("LRMP") that is reasonably designed to assess and manage the fund's liquidity risk. This requirement would extend to each separate series of a registered open-end management investment company, and for purposes of the discussion of proposed rule 22e-4, each such registered open-end investment company or separate series thereof is referred to herein as a "fund."[5] The proposed rule would not apply to closed-end funds or to ETFs organized as unit investment trusts.

Each fund would 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 an ongoing basis, (2) assess and periodically review 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.[6] In addition, the fund's board of directors, including a majority of its independent directors, must approve the LRMP and review the adequacy and implementation of the LRMP on at least an annual basis.

The expected compliance dates for rule 22e-4 are 18 months after the effective date of the new rules for funds with net assets of $1 billion or more, and 30 months for smaller funds.

1. Classification of Liquidity of Portfolio Assets

As part of its LRMP, a fund would be required to classify each of the fund's portfolio positions (or portions thereof) based on its relative liquidity and engage in an ongoing review of such classifications. The classifications would be based on the number of days in which the fund determines, using information obtained after reasonable inquiry, that the fund's position (or portion thereof) would be convertible to cash at a price that does not materially affect the value of that asset immediately prior to sale, and must be sorted into the following set categories:

- convertible to cash within 1 business day;
- convertible to cash within 2-3 business days;
- convertible to cash within 4-7 calendar days;
- convertible to cash within 8-15 calendar days;
- convertible to cash within 16-30 calendar days; and
- convertible to cash in more than 30 calendar days.[7]

Funds would be permitted to classify different portions of a single position separately.[8] The proposed rule[9] would require a fund to take the following factors into account in classifying the liquidity of each portfolio position, to the extent applicable with respect to the asset (or similar assets, to the extent data on the portfolio asset is not available to the fund):

- 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.

Expanding on how an asset's relationship to another portfolio asset might affect its liquidity, the SEC noted that assets that have been "segregated" in order to cover a fund's obligations under reverse repurchase agreements, derivatives or certain other instruments in accordance with the SEC guidance set forth in Investment Company Act Release No. 10666 should generally be classified based on the liquidity of the derivative or other instrument they are covering, despite the fact that they might be considered more liquid when considered in isolation, because such assets are considered "frozen" and unavailable for sale or disposition, including for redemptions.[10]

The SEC acknowledged that the relevant considerations for evaluating a position's liquidity could vary depending on the particular asset, and therefore a fund could focus more on certain factors than others, or consider other pertinent factors in addition to those enumerated. The SEC also recognized that different funds may properly classify the same asset at different liquidity levels based on divergent opinions regarding the asset's liquidity or idiosyncratic firm-specific risks affecting the analysis.[11] Finally, funds would be required to regularly review and update the liquidity classification of assets, though the proposed rule does not prescribe specific procedures for such review.

The proposed classification process would operate alongside existing SEC liquidity guidelines, which would be retained and codified in the proposed rule, limiting a fund from investing more than 15% of its net assets in assets that the fund determines at the time of acquisition could not be sold or disposed of within seven days at approximately stated value.

2. Assessment and Review of Liquidity Risk

In addition to the requirement to classify each position by liquidity, proposed rule 22e-4 would require each fund to assess and periodically review the fund's overall liquidity risk, taking into account a list of factors specified in the proposed rule.[12] Factors required to be taken into account in the fund's initial assessment of liquidity risk and subsequent periodic reviews include:

- short-term and long-term cash flow projections, taking into account 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;
- investment strategy and the liquidity of portfolio assets;
- use of borrowings or derivative products for investment purposes;[13] and
- holdings of cash and cash equivalents, as well as borrowing arrangements and other funding sources.

The SEC noted in the proposing 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.[14] In addition, the SEC recognized that some of the proposed factors may not be applicable to certain funds or types of funds (shareholder ownership concentration and fund distribution channels, for example, would generally be more applicable to mutual funds than ETFs), and a fund would not be required to consider any inapplicable factors.

The proposed rule does not prescribe how frequently the required periodic review must be conducted, nor does it specify particular review procedures. Rather, funds would be required to develop and adopt effective, individualized procedures to review liquidity risk that are tailored to the fund's particular circumstances.[15]

3. Management of Liquidity Risk

The proposed rule would define "15% standard asset" 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" and the definition goes on to provide that "the fund does not need to consider the size of the fund's position in the asset or the number of days associated with the receipt of proceeds of sale or disposition of the asset" for purposes of the definition.[16]

The proposed rule would require funds to manage liquidity risk by (1) establishing a "three-day liquid asset minimum," (2) not acquiring any 15% standard assets 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. Three-Day Liquid Asset Minimum

Each fund would be required to determine a "three-day liquid asset minimum," *i.e.*, a minimum percentage of net assets to be invested in assets that the fund believes could be converted to cash within three business days at a price that does not materially affect the value of the asset immediately prior to sale (so-called "three-day liquid assets").[17]

In determining its three-day liquid asset minimum, each fund would 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-term and long-term cash flow projections) and the fund would be required to conduct a review of the adequacy of its three-day liquid asset minimum no less frequently than semi-annually. As with the proposed requirements to monitor the liquidity of portfolio assets and to periodically review liquidity risk, funds would be permitted to develop and adopt their own procedures for conducting this review, taking into account the fund's particular circumstances, provided that the review would be required to include an analysis of the liquidity risk factors set forth in the rule.[18]

The fund would be prohibited from acquiring any non-three-day liquid assets if, immediately after such acquisition, the fund would have less than its three-day liquid asset minimum invested in three-day liquid assets. However, the fund would not be required to constantly manage its portfolio to maintain a certain portion of its net assets in three-day liquid assets. Thus, while a drop in the fund's percentage of net assets invested in three-day liquid assets below the three-day liquid asset minimum would prevent the fund from acquiring any non-three-day liquid assets until its investments in three-day liquid assets meet the three-day liquid asset minimum, it would not force the fund to liquidate less liquid assets in order to raise its percentage of assets invested in three-day liquid assets up to the minimum.

As discussed below, each fund would be required to report its three-day liquid asset minimum on a monthly basis on proposed Form N-PORT. However, only information reported for the third month of each fund's fiscal quarter on Form N-PORT would be publicly available, and not until 60 days after the end of such month.

Explaining its reasons for proposing a three-day liquidity minimum, the SEC noted that, although the Investment Company Act permits funds up to seven calendar days to satisfy redemption requests, in practice, most funds sell at least some of their shares through broker-dealers, and are therefore required under rule 15c6-1 under the Securities Exchange Act of 1934 to meet redemptions within three business days. Moreover, many investors expect to receive redemption proceeds within a shorter time frame than even three days, as some funds disclose in their prospectuses that they will typically satisfy redemption requests within one business day.

b. 15% Standard Asset Limitation

Proposed rule 22e-4 would codify existing SEC guidance restricting funds from investing more than 15% of their net assets in illiquid assets. In particular, a fund would be prohibited from acquiring any 15% standard asset, if, immediately after the acquisition, the fund would have more than 15% of its total assets invested in 15% standard assets.[19] The provision would not require a fund to liquidate 15% standard assets if they rose above 15% of the fund's net assets.

c. Policies and Procedures Regarding Redemptions in Kind

The proposing release notes that along with ETFs, which commonly redeem shares in-kind, many mutual funds reserve the right to redeem their shares in-kind rather than in cash. In-kind redemptions may function as a tool for managing liquidity risk under certain circumstances—by redeeming shares in kind, funds can pass the costs of liquidating less liquid assets onto the redeeming shareholder. Given the potential role of in-kind distributions in managing liquidity risk, the SEC is proposing that funds that engage in or reserve the right to engage in redemptions in-kind must adopt and implement written policies and procedures regarding such in-kind redemptions. The SEC expects such policies and procedures to set forth the process for in-kind redemptions and the circumstances in which the fund would consider redeeming in-kind.

4. Board and Independent Director Approval

Under proposed rule 22e-4, a fund's board of directors would be required to approve and oversee the operation of the fund's LRMP. In particular:

- the fund would be required to obtain initial approval of the LRMP (including the fund's three-day liquid asset minimum), as well as any material change to the LRMP (including a change to the three-day liquid asset minimum), from the fund's board of directors, including a majority of independent directors;
- the fund's board of directors, including a majority of independent directors, would be required to review, no less frequently than annually, a written report from the fund's investment adviser or officers administering the LRMP describing the adequacy of the fund's LRMP (including the three-day liquid asset minimum) and the effectiveness of its implementation; and
- the fund's board of directors, including a majority of its independent directors, would be required to 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.

The proposing release states that directors could satisfy their obligations with respect to the initial approval process by reviewing a summary of the LRMP prepared by the fund's adviser, officers or other individuals familiar with the LRMP. The summary should familiarize directors with the key features of the LRMP and explain how the LRMP addresses the fund's assessment of liquidity risk, including how the three-day liquid asset minimum was determined. In evaluating a fund's LRMP, directors may also wish to consider recent experiences regarding the fund's liquidity, such as a high volume of redemptions.

The SEC emphasized the "critical role" played by a fund's independent directors in overseeing fund operations, particularly in areas presenting potential conflicts of interest between the fund and its investment adviser. The adequacy of a fund's LRMP warrants particular scrutiny by the independent directors because portfolio managers may have an incentive to set a low three-day liquid asset minimum in order to enable the fund to invest more heavily in assets which would not count towards the three-day liquid asset minimum, resulting in higher total returns for the fund.

5. Recordkeeping Requirements

Proposed rule 22e-4 would require the fund to keep certain records pertaining to a fund's LRMP to facilitate review by SEC examiners. In particular, a fund would be required to maintain:

- copies of its policies and procedures relating to the LRMP, for five years in an easily accessible place;
- copies of materials provided to the board of directors in connection with the board's initial approval of the LRMP, any subsequent material changes to the LRMP, including any changes to the three-day liquid asset minimum, and copies of the written reports provided to the board in connection with its periodic review of the LRMP, for at least five years, the first two years in an easily accessible place; and

- a written record of how the three-day liquid asset minimum (and any subsequent adjustments) was determined, for at least five years, the first two years in an easily accessible place.

6. Guidance on Other Liquidity Management Tools

The SEC emphasized in the proposing release that in addition to the elements specifically required to be included in LRMPs pursuant to proposed rule 22e-4, funds would be permitted to incorporate other risk management strategies, and therefore included guidance in the release on certain commonly used practices for managing liquidity risk, including the entry into borrowing or other funding arrangements to assist in meeting shareholder redemptions, the use of ETF portfolio holdings as a liquidity management tool and so-called "cross-trading." The SEC also noted that money market funds are currently permitted, under certain circumstances, to permanently suspend redemptions and liquidate, and requested comment on whether such an option should be made available to other types of funds.

SWING PRICING

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 the close of the fund's primary underlying market (typically 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 market impact costs[20] and spread costs[21] incurred by the fund in order to meet the purchase or redemption request.[22] Rather, such costs are borne by the fund's existing or non-redeeming shareholders. 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 has proposed to amend rule 22c-1 to permit, but not require, each registered open-end investment 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 would not be permitted to use swing pricing. Such policies and procedures would be required to:

- provide that whenever the level of net purchases into or net redemptions from the fund exceed a specified "swing threshold," the fund will adjust its NAV by a specified "swing factor" (each expressed as a percentage of the fund's NAV);[23]
- specify the fund's swing threshold, 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;[24]
- specify how the swing factor would be determined, and any upper limit on the swing factor, taking into account (1) 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 market impact costs, spread costs and 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 (2) the value of assets purchased or sold by the fund as a result of net purchases or redemptions occurring on the day the swing factor is applied, if that information would not otherwise be reflected in the NAV calculated that day; and
- provide for the periodic review, no less frequently than annually, of the fund's swing threshold.[25]

The adoption of swing pricing policies and procedures, and any material changes to such policies and procedures (including any change to the swing threshold or the swing factor upper limit or any decision to suspend or terminate the fund's swing pricing policies), would be subject to approval by the fund's board of directors, including a majority of independent directors.[26] In addition, the board would 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 officer (provided that determination of the swing factor would be required to be "reasonably segregated" from the fund's portfolio management function).[27]

If final information regarding the level of net purchases or net redemptions on any given day is not available until after the deadline for striking the fund's NAV on such day, for purposes of determining whether the swing threshold has been exceeded, the person responsible for administering the swing pricing policies would be permitted to estimate the total net purchases or redemptions on such day based on information obtained after reasonable inquiry.

The proposed amendments to rule 22c-1 would require a fund to maintain a written copy of its swing pricing policies and procedures. In addition, rule 31a-2, which requires a fund to maintain records of each NAV calculation, would be 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.

DISCLOSURE AND REPORTING REQUIREMENTS

The proposed rules would amend Form N-1A, proposed Form N-PORT and proposed Form N-CEN to require additional disclosure and reporting by open-end funds regarding the liquidity of their portfolio assets and their liquidity risk management practices.[28] The proposed 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-1A and Regulation S-X would be amended to require certain disclosure regarding a fund's use of swing pricing.

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

The proposed amendments would require a fund to disclose on Form N-1A the number of days in which it will pay redemption proceeds to investors. Moreover, a fund would be required to 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. Noting that many funds have established lines of credit to manage liquidity risk and meet redemptions, the SEC has also proposed that funds be required to file as exhibits to the Form N-1A any agreements related to lines of credit.

Funds that elect to adopt swing pricing procedures would be required to provide disclosures in Form N-1A concerning the circumstances under which swing pricing would be used and the effects thereof. In addition, funds would be required to discuss the impact of swing pricing in the notes to their financial statements. The expected compliance date for the amendments to Form N-1A is six months after the effective date, except for the amendments related to swing pricing, which would be effective immediately.

2. Proposed Form N-PORT

The amendments to proposed Form N-PORT would require detailed reporting regarding fund liquidity risk management. In particular, funds would be required to report the liquidity classification of each of the fund's positions in a portfolio asset under the fund's LRMP, whether each portfolio asset is a "15% standard asset" and the fund's target three-day liquid asset minimum. The expected compliance dates for the proposed amendments to Form N-PORT are 18 months after the effective date for funds with net assets of $1 billion or greater, and 30 months for smaller funds.

3. Proposed Form N-CEN

Proposed Form N-CEN would be amended to require 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, funds would report information regarding any lines of credit maintained by a 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, 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 during the reporting period. The expected compliance date for the proposed amendments to Form N-CEN is 18 months after the effective date.

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ENDNOTES

1 *See* "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").

2 At the SEC meeting at which the proposals were approved, Chair White referred to a report, released by the SEC's Division of Economic and Risk Analysis in connection with the proposed rules, finding that funds utilizing alternative investment strategies typically experience greater volatility of flows than funds employing other investment strategies. *See* Paul Hanouna, Jon Novak, Tim Riley, Christof Stahel, "Liquidity and Flows of U.S. Mutual Funds," Division of Economic and Risk Analysis White Paper, September 2015, *available at* : http://www.sec.gov/dera/staff-papers/white-papers/liquidity-white-paper-09-2015.pdf.

3 *See* "SEC Proposes Rules to Modify Reporting Regime for Registered Investment Companies and Investment Advisers" (May 26, 2015) *available at* https://sullcrom.com/sec-proposes-rules-to-modify-reporting-regime-for-registered-investment-companies-and-investment-advisers.

4 *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* http://sullcrom.com /siteFiles/Publications/SC_Publication_Asset_Management_and_Financial_Stability.pdf.

5 The proposing release notes that the SEC "anticipate[s] that liquidity risk could differ—sometimes significantly—among the series of an investment company, based on variations in each of the proposed liquidity risk assessment factors required to be considered," requiring each series' liquidity risk management program to incorporate distinct risk assessment and risk management elements. However, "to the extent that the series of an investment company are substantially similar in terms of cash flow patterns, investment strategy, portfolio liquidity and the other factors a fund would be required to consider in assessing its liquidity risk, it may be appropriate for each series to adopt the same or a similar liquidity risk management program." *See* page 46 of the Proposing Release.

6 *See* proposed rule 22e-4(b)(1).

7 *See* proposed rule 22e-4(b)(2)(ii).

8 For example, if a firm held a significant position in a particular large-cap equity security, and determined that it could convert half of such position into cash within one business day without materially affecting the value of the position but would require two to three business days to convert the remainder to cash without so affecting its value, it would separately classify such portions accordingly.

9 *See* proposed rule 22e-4(b)(2)(ii)(A)-(I).

10 *See* page 95 of the Proposing Release; *see also* "Securities Trading Practices of Registered Investment Companies, Investment Company Act Release No. 10666" (Apr. 18, 1979) ("Release 10666").

11 However, where a firm has not previously dealt in a particular asset, or lacks pertinent information about it, the fund would be required to consider the listed factors as applied to similar assets.

12 The proposed rule defines "liquidity risk" as "the risk that the fund could not meet requests to redeem shares issued by the fund that are expected under normal conditions, or are reasonably foreseeable under stressed conditions, without materially affecting the fund's net asset value." *See* proposed rule 22e-4(a)(7).

ENDNOTES (CONTINUED)

13 Because funds would generally be required, pursuant to Release 10666, to segregate liquid assets in order to cover their obligations under reverse repurchase agreements, short sales, derivatives or other financing transactions, the SEC noted that a fund's assessment of liquidity risk should include an evaluation of the nature and extent of its borrowings and derivatives and the potential impact of such transactions on the fund's liquidity profile. *See* page 95 of the Proposing Release.

14 For example, according to the proposing release, if a fund elects to conduct stress testing to evaluate its liquidity risk, it should consider incorporating the results of such testing into its liquidity risk assessment. *See* page 108 of the Proposing Release.

15 The proposing release notes that, because a fund's liquidity risk is related to the liquidity of its portfolio assets, a fund may wish to adopt liquidity risk review procedures that reference its procedures for monitoring the liquidity of its positions in portfolio assets, *e.g.*, by specifying that a fund would undertake a liquidity risk review in response to events that result in revisions to the liquidity classification of portfolio assets. *See* page 130 of the Proposing Release.

16 *See* proposed rule 22e-4(a)(4).

17 Proposed rule 22e-4(b)(2)(iv)(A)-(C). The determination of whether a position in a portfolio asset is a "three-day liquid asset" would be required to be based on the same factors used in determining the position's liquidity classification for purposes of rule 22e-4(b)(2)(ii).

18 The proposed rules would not establish a "floor" for the three-day liquid asset minimum. However, in the proposing release the SEC noted that it would be "extremely difficult [for a fund] to conclude . . . that a zero three-day liquid asset minimum would be appropriate." *See* page 138 of the Proposing Release.

19 The definition of "15% standard asset" is intended to be consistent with how funds currently classify "illiquid assets" for purposes of complying with the SEC's 15% guideline. So, for purposes of determining whether an asset is a "15% standard asset," the fund would not be required to consider the size of its position in the asset or the time when the proceeds from the sale or disposition would be received. The test thus differs from that under the proposed liquidity classification framework, which is based on how quickly a position (or portion thereof) can be converted into cash, taking account of the position's size and other factors. *See* page 152 of the Proposing Release.

20 The proposing release defines "market impact costs" as costs incurred where the price of a security changes as a result of the effort to purchase or sell the security.

21 The proposing release defines "spread costs" as costs incurred indirectly when a fund buys a security from a dealer at the "asked" price (slightly above current value) or sells a security to a dealer at the "bid" price (slightly below current value).

22 *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.

23 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. The proposing release notes that the SEC considered a version of the rule that would have permitted funds to quote separate prices for redeeming and purchasing shareholders (a process used by several foreign funds known as "dual pricing"), but concluded that it would be more difficult to implement and confusing to investors. The SEC also noted that purchasing activity on days when a downward NAV adjustment is in effect would provide liquidity to the fund and thereby tend to reduce the swing factor. However, the SEC requested comment

on whether dual pricing would be more effective at mitigating dilution than swing pricing. *See* pages 196 and 199 of the Proposing Release.

24 Under the proposed rules, a fund would not be required to publicly disclose its swing threshold. *See* page 200 of the Proposing Release.

25 *See* proposed rule 22c-1(a)(3)(i)(C).

26 The proposing release notes that the decision to implement swing pricing could create conflicts of interest between the fund and its adviser, therefore meriting special scrutiny by the fund's independent directors. For example, advisers may wish to avoid implementing swing pricing out of concern that the adjustments to NAV caused by swing pricing may cause the fund's performance to appear more volatile than the fund's benchmark, hindering the fund's ability to attract new investors. *See* page 232 of the Proposing Release.

27 The SEC noted that among foreign domiciled funds that currently use swing pricing, common industry practice is to appoint a committee to administer swing pricing operations, and suggested that fund boards may wish to consider such an approach, specifying the officers or functional areas comprising the committee. *See* page 233 of the Proposing Release.

28 For more information regarding proposed Forms N-PORT and N-CEN, *see supra* note 3.

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CONTACTS

New York		
John E. Baumgardner Jr.	+1-212-558-3866	baumgardnerj@sullcrom.com
Whitney A. Chatterjee	+1-212-558-4883	chatterjeew@sullcrom.com
Donald R. Crawshaw	+1-212-558-4016	crawshawd@sullcrom.com
William G. Farrar	+1-212-558-4940	farrarw@sullcrom.com
David J. Gilberg	+1-212-558-4680	gilbergd@sullcrom.com
Frederick Wertheim	+1-212-558-4974	wertheimf@sullcrom.com
Washington, D.C.		
Eric J. Kadel Jr.	+1-202-956-7640	kadelej@sullcrom.com
Samuel R. Woodall III	+1-202-956-7584	woodalls@sullcrom.com
Paul J. McElroy	+1-202-956-7550	mcelroyp@sullcrom.com