U.S. SEC PROPOSES LIQUIDITY RISK MANAGEMENT PROGRAMS, OPTIONAL "SWING PRICING," AND LIQUIDITY REPORTING FOR MUTUAL FUNDS AND CERTAIN ETFS

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Investment Management, Hedge Fund and Alternative Investments Alert

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INTRODUCTION

On September 22, 2015, the Securities and Exchange Commission ("**SEC**") proposed a new rule and amendments to rules and reporting forms under the Investment Company Act of 1940 (the **"1940 Act"**), designed to standardize liquidity risk management by open-end funds.[1] If adopted, the reforms would:

- Require open-end management investment companies (including certain exchange-traded funds ("**ETFs**") but excluding money market funds) to adopt a written liquidity risk management program with two key elements: first, requiring a fund to classify the liquidity of each fund holding into one of six prescribed categories, and second, requiring a fund to establish a minimum amount of assets it must hold in so-called "three-day liquid assets" — assets that can be readily liquidated in three business days without materially affecting the assets' market value prior to completing the sale;
- Permit open-end management investment companies (other than money market funds and ETFs) to use "swing pricing" — a process of adjusting the net asset value (**"NAV"**) of fund shares so that purchasing or redeeming investors would bear a portion of the costs of entering or exiting the fund under certain circumstances; and
- Require open-end funds (other than money market funds) and certain ETFs to disclose information about the liquidity of their portfolios, and about how they manage liquidity risk and redemption obligations in accordance with the proposed reforms.

The proposed rules, if adopted, may have far reaching effects on the funds that are subject to their provisions. Open-end funds can expect to incur costs, which could be substantial, in implementing or modifying liquidity risk management programs and making the required reports and disclosures. To the extent that funds rely on third-party service providers to provide liquidity data and analyses, they will also incur the associated expenses. Funds that elect to use swing pricing will face challenges in setting the mechanism for adjusting NAV and communicating this new process to shareholders. Fund boards will face significant new oversight responsibilities. The SEC also expects to use the information gleaned from fund disclosures when conducting examinations and in enforcement actions.

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BACKGROUND OF PROPOSED REFORMS

The proposed reforms represent for open-end funds (other than money market funds) the first liquidity guidance from the SEC in over 20 years. The reforms are focused on standardizing liquidity management practices among funds by requiring a formal, written liquidity risk program with board oversight and frequent monitoring.

Liquidity risk in the asset management industry has become an increasing focus of regulatory concern. Over the past two years, the SEC staff has made fixed income and so-called "alternative" funds and their liquidity management practices an examination priority. The staff observed that liquidity risk management practices among funds vary significantly and that some funds, when faced with a high level of redemptions, "experienced particularly poor performance compared with their benchmark," creating a risk of investor dilution. The SEC notes that these varying practices, combined with a trend in the industry toward non-equity portfolio investments, necessitate an enhanced "minimum baseline requirement" for the management of liquidity risk across the mutual fund industry.

The reforms are also aimed more broadly at managing risk to the U.S. financial system as a whole. In December 2014, the Financial Stability Oversight Council ("**FSOC**") sought public comment about potential risks to the U.S. financial system associated with liquidity and redemptions in the asset management industry. Although FSOC's public comment request is independent of the proposed reforms, the SEC notes that it considered comments to FSOC in formulating its rule proposal. The SEC explains in the Proposing Release that, "as the primary regulator of open-end funds," it remains committed to designing regulatory programs that "focus on mitigating the adverse effects that liquidity risk in funds can have on investors and the fair, efficient and orderly operation of the markets," including "any potential financial stability risks from poor fund liquidity management."

FAST FACTS ABOUT THE PROPOSED REFORMS

A. New Rule 22e-4 under the 1940 Act

Scope: The rule requirements **apply** to all registered open-end management investment companies except money market funds. Accordingly, the requirements: (i) **apply** to open-end ETFs, including actively-managed open-end ETFs, **but not** to ETFs structured as unit investment trusts, and **do not apply** to closed-end funds.

Requirements: The rule requires a fund to establish and implement a written program designed to assess and manage the fund's liquidity risk.

- "Liquidity risk" is defined 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 NAV."
- The rule would require a fund's liquidity risk management program to address, at a minimum, the following elements: (1) classification of the liquidity of each of the fund's holdings into one of six categories, based on an analysis of a set of prescribed factors, and an ongoing review of those classifications; (2) based on these classifications, an assessment and a periodic review of the fund's liquidity risk; and (3) based this assessment, the establishment of a "three-day liquid asset minimum" — a minimum percentage of the fund's assets that must be convertible to cash within three business days at a price that does not materially affect the value of the asset immediately prior to sale.

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- In addition to the foregoing new requirements, the rule would codify the SEC's current guidance on open-end fund liquidity by prohibiting a fund from acquiring any "15% standard asset" if the fund would have invested more than 15% of its net assets in 15% standard assets.
    - A "15% standard asset" would be defined as "any asset that may not be sold or disposed of in the ordinary course of business within seven calendar days at approximately the value ascribed to it by the fund." The definition conforms to the definition of "illiquid" assets under the current guidance, but *differs* from the concept of liquidity under the proposed rule, which categorizes liquidity based on a spectrum rather than binary liquid/illiquid categories.
- A fund's board of trustees must (1) initially approve the fund's written liquidity risk management program, (2) approve the appointment of the investment adviser and officers responsible for administering the program, (3) review and approve any material changes to the program, and (4) review a written report on the program and its implementation at least annually.

Compliance Dates: The proposed compliance dates differ depending on the size of the fund group, as follows:

- *18 months after the effective date* for funds that, together with other investment companies in the same group of related investment companies, have net assets of $1 billion or more as of the end of the most recent fiscal year.
- *30 months after the effective date* for all other funds subject to the rule.

B. Amendments to Rule 22c-1 under the 1940 Act

Scope:"Swing pricing" would be ***permitted*** for registered open-end management investment companies, ***except***: (i) ETFs and (ii) money market funds.

Requirements: Funds authorized to use swing pricing would be permitted, but not required, to establish and implement policies and procedures providing for the fund to adjust its current NAV to mitigate dilution of the value of its outstanding redeemable securities as a result of shareholder purchases and redemptions.

- A fund's board of trustees (including a majority of the independent trustees) must approve swing pricing policies and procedures, and the policies and procedures must include certain specified elements.
- A fund's swing pricing policies and procedures must provide that the fund will adjust its NAV by a "swing factor" amount once the level of net purchases into or net redemptions from the fund has exceeded a "swing threshold."

Compliance Date: For funds that elect to use swing pricing, the SEC expects the rule, if adopted, would be available immediately after the effective date once a fund has met the requirements of the rule.

C. Proposed Disclosure and Reporting Requirements

Amendments to Form N-1A

Requirements: The current requirements of Form N-1A (i.e., the form used by open-end management investment companies to register under the 1940 Act) do not require disclosure of the timing of payment of redemption proceeds to fund shareholders, and the SEC notes that the level of disclosure consequently varies among funds. The SEC is therefore proposing amending Form N-1A to add certain line-item requirements that

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would establish consistency in disclosures among funds, and to seek to ensure that investors receive adequate information to compare redemption policies across funds. The following items and instructions would be amended:

- *Item 6 of Form N-1A* would be amended to require any fund that uses swing pricing to explain the circumstances under which swing pricing would be required to be used, as well as the effects of using swing pricing.
- *Item 11 of Form N-1A* would require a fund to disclose the: (1) number of days in which the fund will pay redemption proceeds to redeeming shareholders, and (2) methods the fund uses to meet redemption requests.
- *Item 13 of Form N-1A* would require any fund that uses swing pricing to disclose the per-share effect of amounts related to swing pricing below the total distributions line in a fund's financial highlights.
- *Instructions to Item 26 of Form N-1A* would be revised to clarify that "ending redeemable value" should assume a value adjusted pursuant to swing pricing policies and procedures.
- *Item 28 of Form N-1A* would require a fund to file as an exhibit to its registration statement any agreement related to lines of credit for the benefit of the fund. The fees paid under the credit agreements would not need to be disclosed.

Compliance Date: All initial registration statements on Form N-1A and all post-effective amendments that are annual updates to effective registration statements on Form N-1A that are *filed six months or more* after the effective date must comply with the proposed amendments.

Amendments to Regulation S-X

Requirements: Because the use of swing pricing would affect a fund's statement of assets and liabilities, statement of changes in net assets, financial highlights and the notes to the financial statements, certain amendments to Regulation S-X are proposed for any fund that uses swing pricing:

- *Rule 6-04.19 of Regulation S-X* would require a fund to disclose its NAV as adjusted pursuant to any swing pricing policies and procedures.
- *Rule 6-03(n) of Regulation S-X* would require a fund to state in a note to its financial statements the general methods used in determining whether the fund's NAV per share will swing, whether the fund's NAV per share has swung during the year and a general description of the effects of swing pricing on the fund's financial statements.

Compliance Dates: For funds that elect to use swing pricing, the SEC expects the amendments, if adopted, would be available immediately after the effective date once a fund has met the requirements of the rule.

Amendments to Proposed Form N-PORT

Requirements: The SEC recently proposed new reporting forms — Forms N-PORT and N-CEN — intended to capture key information about funds' investment practices on a more frequent basis and in a format that better enables the SEC staff to aggregate and analyze the data.[2] The SEC proposes to amend proposed Form N-

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PORT, a monthly reporting form, to require additional information about fund liquidity related to non-money market, open-end funds:

- *Item B.7* would be added to Part B of proposed Form N-PORT to require a fund to disclose its three-day liquid asset minimum, in accordance with Rule 22e-4.
- *Item C.13* would be added to Part C of proposed Form N-PORT and would require a fund to report the liquidity classification of each of its portfolio holdings.
- *15% Standard Asset Disclosure*. As currently proposed, Form N-PORT requires that a fund disclose whether each particular portfolio security is an "illiquid" asset. The term "illiquid" asset would be revised to use terminology from Rule 22e-4, as described above (i.e., 15% standard asset).

Compliance Dates: Thecompliance dates differ depending on the size of the fund group, as follows:

- 18 months after the effective date for funds that, together with other investment companies in the same group of related investment companies, have net assets of $1 billion or more as of the end of the most recent fiscal year.
- 30 months after the effective date for all other funds subject to the rule.

Amendments to Proposed Form N-CEN

Requirements: Proposed Form N-CEN, an annual reporting form, would be amended to require additional information about liquidity management practices:

- *Item 44* would be added to Part C of proposed Form N-CEN to include certain questions regarding the use of lines of credit, interfund lending, interfund borrowing and swing pricing.
- *Item 60(g)* would be added to proposed Form N-CEN to require an ETF to report whether it required that an authorized participant post collateral to the ETF or any of its designated service providers in connection with the purchase or redemption of ETF shares during the reporting period.

Compliance Date: 18 months after the effective date.

AN IN-DEPTH LOOK AT THE PROPOSED REFORMS

The Purpose of the Proposed Reforms

Meeting daily redemptions is fundamental to the operation of open-end funds. The SEC explains that a "hallmark of open-end funds is that they must be able to convert some portion of their portfolio holdings into cash on a frequent basis." The proposed reforms have three primary purposes: (1) to reduce the risk that funds will be unable to meet redemption obligations, (2) to protect long-term fund shareholders from dilution of their interests caused by fund inflows and outflows and (3) to enhance fund disclosures about liquidity and redemption practices.

The SEC points to industry developments that underscore the need for its proposals, including increasing shareholder inflows into funds with less liquid investment strategies, such as fixed income, emerging market debt and alternatives. The SEC notes that many alternative funds pursue strategies similar to those of private funds, but unlike private funds, are unable to restrict investor redemption rights and must honor redemption requests within seven days. Citing the SEC staff's finding that these funds' cash flows are "significantly more volatile than

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other strategies," the SEC believes the reforms are necessary to address increased redemption risks posed to investors.

Evolving redemption practices, including shortening settlement periods, also underlie the proposed reforms. Although open-end funds must pay redeeming investors for fund shares within seven days of their tender under Section 22(e) of the 1940 Act, over the past two decades, this settlement period has shrunk as a result of the adoption in 1993 of Rule 15c6-1 under the Securities Exchange Act of 1934, which requires broker-dealers, including those that distribute open-end funds, to settle trades within three business days (called "T+3"). The settlement period for fund share transactions can be even shorter, as some open-end funds promise settlement on a next-business-day basis. However, the SEC notes that while settlement periods for trading fund shares have fallen, settlement periods for some portfolio securities that funds hold — such as bank loans — have not fallen correspondingly, and can exceed seven business days. The SEC is concerned that this potential mismatch between the time in which a fund receives cash for selling a portfolio asset and the time the fund must pay its redeeming shareholders could increase a fund's liquidity risk and affect its ability to meet redemptions.

Separate from the risk that a fund may not be able to satisfy its redemption obligations, there is the risk that investor inflows and outflows could dilute the interests of longer-term investors in the fund. A 2015 SEC staff white paper on fund liquidity concluded that the typical U.S. equity fund appears to sell relatively more liquid assets first to meet redemptions, thus leaving remaining shareholders with a potentially less liquid and riskier fund until the fund rebalances.[3] Further, to the extent that funds conduct trading activity and incur the associated costs in the days after a redemption request, these costs are not reflected in the NAV paid to redeeming investors and are instead borne by remaining investors. The swing pricing amendments to Rule 22c-1 under the 1940 Act seek to reduce this "first mover advantage" to early redeeming shareholders and protect longer-term fund shareholders from dilution. The SEC based its proposal in large part on pricing practices of funds in European jurisdictions, including "UCITS" funds organized in Luxembourg.

The proposed disclosure reforms go beyond informing investors about funds' liquidity and redemption practices, as they are also intended to enhance the SEC's ability to monitor liquidity management risk in the fund industry. Proposed amendments to Form N-PORT would require a fund to report the liquidity classification of each position (or portion of a position) in a portfolio asset monthly, as well disclose its established three-day liquid asset minimum. The SEC anticipates that the additional reporting will assist its staff to better monitor liquidity trends and various funds' liquidity risk profiles. For example, a fund that experiences lower performance than its peers during periods of high redemptions may expect increased regulatory scrutiny.

Proposed Rule 22e-4: Liquidity Risk Management Programs

Although Proposed Rule 22e-4 would apply to all open-end management investment companies (other than money market funds) regardless of their specific investment strategies, it would require each fund to assess its own liquidity risk and adopt tailored policies and procedures for managing liquidity risk in light of that assessment. The effect of the proposal is that funds whose assets are concentrated in less liquid assets likely will establish liquidity risk management programs that are substantially different from programs established by funds whose assets are highly liquid.

1. Portfolio Classification Requirements

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Overview

Under proposedRule 22e-4, a fund would be required to classify each position (or each portion of a position) in a portfolio asset into one of six categories based on the relative liquidity of the position. The classification would be based on the number of days within which it is determined, after reasonable inquiry, that the entire position would be "convertible to cash"[4] at a price that does not materially affect the value of the asset immediately prior to sale (i.e., taking into account whether the sales price that the fund would receive for the asset is reasonably expected to move the price of the asset in the market, independent of other market forces affecting the asset's value). In making this determination, a fund could determine that different portions of a position in a particular asset could be converted to cash within different times. However, the liquidity assessment must assume that the entire position is liquidated.

The rule does not assign liquidity categories to any particular asset class, and the SEC contemplates that different funds could classify the liquidity of identical portfolio positions differently depending on the funds' liquidity analysis. However, each fund is required to consider, at a minimum, a non-exhaustive set of factors in analyzing an asset's liquidity. If a fund lacks pertinent information about a particular asset, the fund would be required to consider these factors as applied to "comparable assets."

List of Asset Classification Factors

The factors that a fund must consider are as follows:

- 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

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- Relationship of the asset to another portfolio asset (e.g., whether the asset is being maintained in a segregated account in order to “cover” the fund's obligations under a transaction that implicates Section 18 of the 1940 Act).

Importantly, the Proposing Release makes clear that the SEC staff will be able to determine if a fund is an outlier with respect to its liquidity classifications based on its monthly disclosures on Form N-PORT, and that the staff could then use that information to examine the fund to determine whether the fund considered each of the required factors.

Asset Classification Categories

Based on an analysis of a portfolio asset's liquidity considering the above factors, a fund would be required to classify each position in a portfolio asset into one of six liquidity categories, as follows:

- 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.
- Convertible to cash in more than 30 **calendar** days.

Ongoing Review of Asset Classifications

A fund's asset classifications must be reviewed on an “ongoing” basis. However, except for requiring funds to consider the liquidity factors discussed above, proposed Rule 22e-4 does not mandate specific review procedures. Nevertheless, the Proposing Release recommends that in adopting ongoing review policies and procedures, a fund should generally include procedures for identifying market-wide developments as well as security- and asset class-specific developments that could demonstrate a need to change the liquidity classification of a portfolio position. Because a fund would report its liquidity positions monthly on proposed Form N-PORT, funds would need to conduct reviews at least monthly.

2. Assessing a Fund's Liquidity Risk

Overview

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In addition to classifying and engaging in an ongoing review of a fund's positions, or portions of a position, in a portfolio asset, proposed Rule 22e-4 requires a fund to assess and periodically review the fund's liquidity risk, taking into account certain factors. Liquidity risk is defined 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." This definition contemplates that a fund consider both expected requests for redemptions in the normal course and outflows related to stressed market conditions or increased volatility, as well as outflows that are reasonable to expect in light of a reputational event affecting the fund or the departure of the fund's portfolio manager.

Required Factors in Assessing a Fund's Liquidity Risk

Under proposed Rule 22e-4, the liquidity risk assessment is largely principles-based and permits a fund to implement liquidity risk management procedures in accordance with the fund's particular risks and circumstances. However, similar to the asset classifications discussed above, funds are required to consider a set of non-exhaustive baseline factors:

- Short-term and long-term cash flow projections, taking into account the following considerations:
  - 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;
- The fund's investment strategy and liquidity of portfolio assets;
- Use of borrowing and derivatives for investment purposes; and
- Holdings of cash and cash equivalents, as well as borrowing arrangements and other funding sources.

Periodic Review of Liquidity Risk Assessment

The fund's liquidity risk assessment must be reviewed periodically. However, except for requiring funds to consider the various factors discussed above, proposed Rule 22e-4 does not mandate specific review

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procedures. Nevertheless, the Proposing Release recommends that in adopting ongoing review policies and procedures, a fund should generally consider whether to include procedures for evaluating regulatory, market-wide and fund-specific developments affecting each of the above-listed factors.

3. Managing Liquidity Risk

Three-Day Liquid Asset Minimum

In addition to assessing liquidity risk, funds must adopt certain minimum procedures to manage that risk. Accordingly, proposed Rule 22e-4 requires a fund to determine the fund's three-day liquid asset minimum, taking into account the factors previously discussed above in connection with the fund's assessment of its liquidity risk. The rule 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. The rule would not require a fund to divest less liquid assets if it falls below the three-day minimum due to reasons other than the purchase of a less liquid asset. Although the rule does not specify any minimum threshold, the SEC believes "that it would be extremely difficult to conclude, based on the factors [a fund] would be required to consider, that a zero three-day liquid asset minimum would be appropriate." A fund would be required to maintain a written record of how the three-day liquid asset minimum was determined, including the assessment of the required factors.

Periodic Review of Three-Day Liquid Asset Determination

The adequacy of the three-day liquid asset minimum must be reviewed periodically, considering the liquidity risk factors, and in no event less frequently than semi-annually. Although each fund is permitted to develop and adopt its own procedures in light of the fund's risks and circumstances, the SEC describes the three-day liquid asset minimum determination as "a cornerstone of a fund's liquidity risk management." The Proposing Release envisions that such determination will be a dynamic process that incorporates new or updated information into the fund's assessment of factors that could affect the fund's ability to meet redemptions.

15% Standard Asset Limitation

Under proposed Rule 22e-4, a fund could not acquire any "15% standard asset" (i.e., "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") if, immediately after the acquisition, the fund would have invested more than 15% of its total assets in 15% standard assets.

It is worth noting that the three-day liquid asset minimum requirements are in addition to the 15% standard asset

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limitation. Although similar, there are several important differences between the two requirements, including: (1) when determining whether an asset may be sold or disposed of within seven calendar days for purposes of the 15% standard asset requirement, a fund does not need to consider the time at which is expects to receive the proceeds of such a sale, whereas such consideration is required for purposes of the three-day liquid asset minimum; and (2) the definition of 15% standard asset does not require a fund to consider any specific factors, unlike the three-day liquid asset determination.

In adopting the 15% standard asset limitation under the rule, the SEC is proposing to withdraw its previous liquidity guidance. According to the SEC, the proposal provides a more comprehensive framework for funds to evaluate the liquidity of their assets.

In-Kind Redemption Policies and Procedures

Open-end funds generally may reserve the right to redeem their shares in kind instead of in cash (and ETFs commonly redeem in kind). Proposed Rule 22e-4 would require a fund that redeems in kind, or reserves the right to do so, to adopt and implement written policies and procedures for in-kind redemptions. The SEC expects that these policies and procedures would address when and how a fund would redeem in kind. The SEC believes that if funds have such policies and procedures, they may be more likely to use in-kind redemptions as a feasible risk management tool to deal with liquidity pressures, rather than solely as a last resort or emergency measure.

The SEC notes that a fund could choose to process significant redemptions in kind to manage liquidity risk, as the liquidity costs of disposing of portfolio assets would be borne by the redeeming shareholder (and not the fund or remaining shareholders). However, the SEC recognizes that in-kind redemptions could involve complex valuation and operational issues, and some shareholders may be unable or unwilling to receive in-kind redemptions.

Other Ways to Manage Liquidity — Borrowing and Investments in ETFs

*Lines of Credit.*The SEC recognizes that funds can adopt liquidity risk management practices in addition to those mandated by proposed Rule 22e-4, such as making borrowing arrangements (via bank lines of credit, interfund lending within the fund complex or repurchase transactions) or investing in ETFs. Proposed Rule 22e-4 would require a fund to consider any borrowing arrangements and other funding sources in assessing its liquidity risk. Further, the SEC provides guidance for funds that engage in these liquidity risk management practices. The SEC recommends that a fund, in considering how a bank credit facility could affect the fund's liquidity risk, evaluate the terms and amount of the credit facility, whether the credit facility is committed (i.e., obligates the bank to lend to the fund under specified circumstances) or uncommitted and the financial health of the lender. If the credit facility is shared by multiple funds (a common occurrence), the SEC notes that the ability of the credit facility to mitigate the liquidity risk of one fund depends on the degree of liquidity risk applicable to the other borrowing funds. To the extent a fund holds securities issued by a bank with which the fund also has a borrowing

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arrangement, the SEC recommends that the fund consider the degree of its correlated exposure to the bank. The SEC proposes to require a fund to file any credit line agreement as an exhibit to the fund's registration statement.

*Investments in ETFs.*The SEC cautions funds that rely "substantially" on ETF investments to manage liquidity risk to consider whether this practice is appropriate. The SEC notes that "the liquidity of an ETF, particularly in times of declining market liquidity, may be limited by the liquidity of the market for the ETF's underlying securities." The SEC encourages funds to "consider the liquidity of an ETF's underlying securities, as well as the characteristics of the ETF shares themselves, in classifying an ETF's liquidity" for purposes of proposed Rule 22e-4. The SEC states that funds should also take these issues into account when considering the portion of a fund's three-day liquid assets that is invested in ETFs.

Emergency Liquidation. The SEC requests comment on whether open-end funds should be permitted, as an emergency measure, to permanently suspend shareholder redemptions and liquidate, as money market funds are permitted to do.

4. Board Approval Requirements

   Under the proposed rules, a fund's board, including a majority of the independent trustees, must initially approve the fund's liquidity risk management program, including the fund's three-day liquid asset minimum, as well as any material changes. The board may rely on summaries of the program for purposes of its approval.

   The board, including a majority of the independent trustees, must also approve the appointment of the fund's investment adviser or officers responsible for administering the fund's liquidity risk management program. (But administration of the program may not be done solely by portfolio managers.) The proposed rule does not require a specific person (such as a dedicated risk management officer) to be designated as responsible for administering the program. This approach differs from fund compliance programs under Rule 38a-1 of the 1940 Act; that rule requires the board to appoint a chief compliance officer to be responsible for administering the fund's compliance program. Further, in contrast to proposed Rule 22e-4, Rule 38a-1 does not require a fund board to approve changes to a fund's compliance policies and procedures.

   Finally, no less frequently than annually, the board must review a written report prepared by the fund's investment adviser or the officers administering the liquidity risk management program. The report must describe the adequacy of the fund's liquidity risk management program and the effectiveness of its implementation.

5. Recordkeeping

   A fund would be required to maintain a written copy of policies and procedures adopted pursuant to its liquidity risk management program for five years in an easily accessible place. The proposed rule would

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also require a fund to maintain copies of any materials provided to the board, as well as a written record of how the three-day liquid asset minimum was determined, for five years, the first two years in an easily accessible place. **Proposed Rule 22c-1(a)(3): Swing Pricing**

Overview

The swing pricing policies and procedures contemplated under the rule would permit any open-end fund (other than ETFs and money market funds) to adjust its NAV by an amount designated as the swing factor once the level of net purchases into, or net redemptions from, the fund has exceeded a specified percentage of the fund's NAV known as the "swing threshold. Because swing pricing requires the fund's net cash flows to be known before determining whether to adjust the fund's NAV on a particular day, and because the deadline by which a fund must strike its NAV may precede the time that the fund receives final information about its daily cash flows, the designated administrator could determine whether the fund has its exceeded its swing threshold based on information obtained "after reasonable inquiry." In-kind purchases and redemptions would be excluded from the calculation.

The SEC believes that swing pricing could be a useful tool in mitigating potential dilution of fund shareholders. The Proposing Release references studies that "have shown that '[f]unds that apply swing pricing show superior performance over time compared to funds (with identical investment strategies and trading patterns) that do not employ anti-dilution measures,' and that '[s]wing pricing helps preserve investment returns as the value to long-term investors normally exceeds the value of the swing factor applied on entry to or exit from the fund.

The Swing Threshold

A fund would be required to adopt policies and procedures for determining its swing threshold. In specifying its swing threshold, a fund would be required to consider the following factors:

- The size, frequency and volatility of historical net purchases or net redemptions of fund shares during normal and stressed periods;
- The fund's investment strategy and the liquidity of the fund's portfolio assets;
- The fund's holdings of cash and cash equivalents, as well as borrowing arrangements and other funding sources; and
- The costs associated with transactions in the markets in which the fund invests.

The swing threshold must be reviewed no less frequently than annually, considering the above factors. In

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general, a fund's swing threshold should reflect the estimated point at which the fund's net cash flows would trigger the fund's investment adviser to trade portfolio assets in the near term to a degree that generates material liquidity or transaction costs for the fund.

The Swing Factor

A fund would be required to adopt policies and procedures for determining its swing factor, stated as a percentage of the fund's NAV, which, if the swing threshold is exceeded, would dictate the amount by which the fund would be required to adjust its NAV. The fund's swing pricing policies must reflect how the swing factor was determined and whether it would be subject to any upper limit.

In determining a fund's swing factor, the following factors must be taken 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, and transaction fees and charges arising from asset purchases or asset sales to satisfy those purchases and 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 cash flows that occur on the day the swing factor is used to adjust the fund's NAV value per share computed that day.

Board Approval Requirements

The fund's board of trustees, including a majority of the independent trustees, must approve the swing pricing policies and procedures as well as any material change to them. However, the board is not required to manage the administration of the fund's swing pricing policies. Under the proposed rule, the board must designate the fund's investment adviser or officers responsible for administering those policies and for determining the swing factor.

Recordkeeping

The fund's swing pricing policies and procedures currently in effect, as well as any swing pricing policies that were in effect within the past six years, must be maintained in an easily accessible place.

COMMENT PERIOD

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The public comment period for the proposals ends on January 13, 2016 (90 days after publication in the *Federal Register*). The SEC re-opened the comment period for the Reporting Modernization Release, and those comments are due on the same day.

Notes:

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

[2] See Investment Company Reporting Modernization, Release No. IC-31610 (May 20, 2015), available at http://www.gpo.gov/fdsys/pkg/FR-2015-06-12/pdf/2015-12779.pdf (the "**Reporting Modernization Release**"). See also K&L Gates LLP's client alert on these proposals: http://www.klgates.com/sec-proposes-new-reporting-requirements-for-registered-funds-06-25-2015/.

[3] 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://wcm.sec.gov/dera/staff-papers/white-papers/liquidity-white-paper-09-2015.pdf.

[4] Proposed Rule 22e-4 defines "convertible to cash" as "the ability to be sold, with the sale settled." Typical expected settlement periods should be assumed when classifying assets under the rule.

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