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SEC Final Rule on Liquidity Risk Management Programs

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SEC RATIONALE

- Aims to reduce "liquidity risk," defined as the risk that a fund could not meet requests to redeem fund shares without significant dilution of remaining investors' interests in the fund
- Responds to significant increase in inflows into less liquid fund strategies, such as fixed income, emerging market debt, and alternative
- Responds to mutual fund evolution towards a shorter settlement period for open-end fund redemptions
  - Combined with some mutual funds holding more securities with longer settlement periods

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SEC RATIONALE

- Responds to staff-identified variances in liquidity risk management practices at different mutual funds – "promoting stronger and more effective liquidity risk management across open-end funds"

- Provides updated guidance - it has been over 20 years since the SEC last provided guidance regarding the liquidity of mutual funds

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CURRENT REGULATORY FRAMEWORK

- Section 22(e) of the Investment Company Act of 1940 ("1940 Act") provides that no mutual fund shall suspend the right of redemption or postpone the date of payment of redemption proceeds for more than seven days after tender of the security
- Rule 22c-1 under the 1940 Act requires funds to sell and redeem fund shares at a price based on the current NAV next computed after receipt of an order to purchase or redeem fund shares ("forward pricing")
- Current Commission guidelines generally limit a mutual fund's aggregate holdings of "illiquid assets" to 15% of the fund's net assets
  - A portfolio security is considered illiquid if it cannot be sold or disposed of in the ordinary course of business within seven days at approximately the value at which the fund has valued the investment

SCOPE OF THE LIQUIDITY RULE

- **Funds covered:** Open-end funds and open-end exchange traded funds ("ETFs")
  - Includes mutual funds structured as "funds-of-funds"
  - In-Kind ETFs excluded from certain requirements
- **Funds not covered:** Closed-end funds, money market funds; unit investment trusts must conduct a limited liquidity review
- **Compliance Dates:**
  - June 1, 2017 – Amended Form N-1A disclosure
  - December 1, 2018 - Broader LRMP requirements for most funds (fund groups with more than $1 billion in assets under management; June 1, 2019 for all others)

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WRITTEN LIQUIDITY RISK MANAGEMENT PROGRAM

- New Rule 22e-4 – Open-end funds must adopt a Liquidity Risk Management Program that includes:
  - Assessing, managing, and periodically (at least annually) reviewing liquidity risk
  - Categorizing liquidity of its investments into four classifications based on the number of days in which the fund reasonably expects the investment to be convertible to cash (or sold or disposed of, in the case of the third or fourth buckets) in current market conditions
  - Establishing a highly liquid investment minimum
  - Codifying an existing 15% limitation on illiquid investments, but modifies the definition of "illiquid."
  - In-Kind ETFs do not need to classify their assets or establish a highly liquid investment minimum

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WRITTEN LIQUIDITY RISK MANAGEMENT PROGRAM: NOTABLE CHANGES FROM THE PROPOSED RULE

1. Reduces the number of liquidity classifications (from 6 to 4) and permits classification based on asset class

2. Streamlines factors for liquidity risk assessment

3. Requires a fund to adopt procedures to address shortfall in its minimum liquidity level

4. Establishes new Form N-LIQUID which a fund must file with the SEC to report a breach of the 15% illiquid investment limitation or if it falls short of its highly liquid investment minimum for 7 consecutive calendar days

5. Reduces level of board involvement to focus on *overseeing* fund operations and *delegating* day-to-day management (i.e., more closely aligns to a board's role in approving and overseeing a fund's compliance program under Rule 38a-1)

LIQUIDITY RISK

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

Definition of Liquidity Risk

Proposed Rule 22e-4(a)(7)

[T]he risk that a fund could not meet requests to redeem shares issued by the fund that are expected under normal conditions, or are reasonably foreseeable under stressed conditions, without materially affecting the fund’s net asset value

Adopted Rule 22e-4(a)(11)

[T]he risk that a fund could not meet requests to redeem shares issued by the fund <u>without significant dilution of remaining investors’ interests in the fund</u>

WRITTEN LIQUIDITY RISK MANAGEMENT PROGRAM

- Each fund must assess, manage, and periodically review its liquidity risk based on the following, as applicable:
  - Investment strategy and liquidity of portfolio assets during normal and reasonably foreseeable stressed conditions
  - Cash flow projections during normal and reasonably foreseeable stressed conditions
  - Holdings of cash and cash equivalents, as well as borrowing arrangements and other funding sources
  - ETFs must also consider:
    - The relationship between the ETF's portfolio liquidity and the efficiency of the arbitrage function, and
    - The effect of the composition of creation and redemption baskets on the overall liquidity of the ETF's portfolio

Liquidity Risk Factors for Risk Assessment	
Proposed Rule 22e-4(b)(2)(iii)	Adopted Rule 22e-4(b)(1)(i)
Assess and periodically review the fund's liquidity risk, considering the fund's:	Each fund and In-Kind ETF must assess, manage, and periodically review (with such review occurring no less frequently than annually) its liquidity risk, which must include consideration of the following factors, as applicable:
(B) Investment strategy and liquidity of portfolio assets; **(C) Use of borrowings and derivatives for investment purposes; and**	(A) [The fund's] investment strategy and liquidity of portfolio investments during both normal and reasonably foreseeable stressed conditions (including whether the investment strategy is appropriate for an open-end fund, the extent to which the strategy involves a relatively concentrated portfolio or large positions in particular issuers, and the use of borrowings for investment purposes and derivatives);
(A) 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;**	(B) Short-term and long-term cash flow projections during both normal and reasonably foreseeable stressed conditions;
(D) Holdings of cash and cash equivalents, as well as borrowing arrangements and other funding sources	(C) Holdings of cash and cash equivalents, as well as borrowing arrangements and other funding sources;
Not applicable	(D) For an ETF: (i) 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 (ii) The effect of the composition of baskets on the overall liquidity of the ETF's portfolio

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WRITTEN LIQUIDITY RISK MANAGEMENT PROGRAM: LIQUIDITY CLASSIFICATIONS

- Each fund must:
  - Classify each portfolio investment into one of four buckets based on reasonable expectations for days-to-cash or days-to-sale in current market conditions, without significantly changing the market value
  - Consider relevant market, trading, and investment-specific considerations in the classification process
  - Review liquidity classifications at least monthly in connection with Form N-PORT reporting

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WRITTEN LIQUIDITY RISK MANAGEMENT PROGRAM: LIQUIDITY CLASSIFICATIONS

- Each fund may:
  - Classify portfolio holdings by asset class, unless market, trading, or investment-specific considerations with respect to a particular investment are reasonably expected to significantly affect the liquidity characteristics of the investment compared to other holdings within that asset class

Categories of Liquidity Classification	
Proposed Rule 22e-4(b)(2)(i) (six buckets ranging from 1 to 30 days)	Adopted Rule 22e-4(b)(1)(ii) (four buckets ranging from 1 to 7 days)
(A) Convertible to cash within 1 business day **(B) Convertible to cash within 2-3 business days** **(C) Convertible to cash within 4-7 calendar days** **(D) Convertible to cash within 8-15 calendar days** **(E) Convertible to cash within 16-30 calendar days** **(F) Convertible to cash in more than 30 calendar days**	22e-4(a)(6). Highly Liquid Investments ($ ≤ 3): includes cash and investments convertible into cash in 3 business days or less without the conversion to cash significantly changing the market value of the investment 22e-4(a)(12). Moderately Liquid Investments (3 < $ ≤ 7): an investment convertible into cash 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 22e-4(a)(10). Less Liquid Investments (sold ≤ 7, settlement > 7): an investment able to be sold or disposed of in seven calendar days or less without the sale or disposition significantly changing the market value of the investment, but where the sale is reasonably expected to settle in more than seven calendar days 22e-4(a)(8). Illiquid Investments (sold > 7): an investment that cannot be sold or disposed of in seven calendar days or less without the sale or disposition significantly changing the market value of the investment

LIQUIDITY CLASSIFICATIONS:

- Market Depth
  - Determine whether trading varying portions of a position in a particular portfolio investment or asset class, in sizes that the fund would reasonably anticipate trading, is reasonably expected to significantly affect its liquidity
  - If so, the fund must take this determination into account when classifying the liquidity of that investment or asset class
- Derivatives
  - For derivatives transactions that a fund has classified as one of the three less liquid categories, the fund must identify 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 those buckets

ESTABLISH A HIGHLY LIQUID INVESTMENT MINIMUM

- The “highly liquid” investment minimum utilizes the same definition as the first liquidity classification (convertible to cash in three or less business days) (Rule 22e-4(a)(6))
- A fund must establish a highly liquid investment minimum, review it at least annually, and establish policies and procedures for responding to a shortfall (e.g., a dip below the established minimum)
- If a fund experiences a shortfall, it may still purchase assets that are not highly liquid, provided the purchases are in accordance with the fund’s shortfall policies and procedures

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ESTABLISH A HIGHLY LIQUID INVESTMENT MINIMUM

- A fund should consider the factors for liquidity risk assessment when it sets its minimum liquidity level
- A fund must report to its board at its next regular board meeting if it experiences a shortfall or report within 1 day if the shortfall lasts for more than 7 consecutive days
- In-Kind ETFs and funds that primarily hold highly liquid assets (e.g., 50% or more) are not required to establish this minimum, with certain conditions

Establishing the Minimum	
Proposed Rule 22e-4(b)(2)(iv)	Adopted Rule 22e-4(b)(1)(iii)(A)
(A) Establish a "three-day liquid asset minimum," which is the percentage of the fund's net assets to be invested in assets "convertible into cash within three business days at a price that does not materially affect the value of that asset immediately prior to sale"	22e-4(a)(7): Establish a "highly liquid investment minimum," which is the percentage of the fund's net assets that are investments convertible into cash in three business days without significantly changing the market value of the investment
(A) In determining its minimum, a fund must consider factors specified in the rule	(1) In determining its minimum, a fund must consider factors set forth in the rule, but only as applicable
(A) A fund must consider risk factors for both normal and stressed conditions	(1) A fund must consider certain liquidity risk factors for both normal and stressed conditions, but only stressed conditions that are reasonably foreseeable during the period until the next review of the minimum
(B) Periodically review, no less frequently than semi-annually, the adequacy of the fund's three-day liquid asset minimum	(2) Periodically review, no less frequently than annually, the highly liquid investment minimum
22e-4(b)(3)(i): A fund's board must approve the three-day liquid asset minimum	A fund's board need not approve the fund's minimum
22e-4(a)(5): Applicable to all open-end funds	22e-4(b)(1)(iii)(A) and 22e-4(a)(5): In-Kind ETFs and funds whose portfolio assets consist "primarily" of highly liquid investments are exempt from the highly liquid investment minimum requirement

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LIMITATION ON ILLIQUID INVESTMENTS

- Acquire test: No fund or In-Kind ETF may purchase an illiquid investment if, immediately after the acquisition, more than 15% of its net assets would be illiquid investments
- If a fund holds more than 15% of its net assets in illiquid investments (with positive values), it must report to its board within 1 business day with an explanation of the extent and causes of the breach, and its plan to decrease its illiquid investments (this breach must also be confidentially reported to the SEC within 1 business day)

LIMITATION ON ILLIQUID INVESTMENTS

- If the breach lasts more than 30 days, the board must assess whether the plan is still in the best interest of the fund
- A fund must disclose the percentage of its holdings in illiquid investments on Form N-PORT
- Definition of “illiquid” for purposes of the 15% limit is the same definition used for classification purposes– a departure from long-standing SEC guidance

15% Limit on Illiquid Investments	
Proposed Rule 22e-4(b)(2)(iv)(D)	Adopted Rule 22e-4(b)(1)(iv)
"[T]he fund will…[n]ot acquire any 15% standard asset if, immediately after the acquisition, the fund would have invested more than 15% of its [net] assets in 15% standard assets…."	"No fund or In-Kind ETF may acquire any illiquid investment if, immediately after the acquisition, the fund or In-Kind ETF would have invested more than 15% of its net assets in illiquid investments that are assets."
22e-4(a)(4): "15% standard asset" is "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."	22e-4(a)(8): An illiquid investment is "an investment not reasonably expected to be sold or disposed of in seven calendar days or less without the sale or disposition significantly changing the market value of the investment," taking into account relevant market, trading and investment-specific considerations, and considering market depth.
Not applicable	(A) A fund must report an occurrence of illiquid investment holdings beyond 15% to its board within one business day "with 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 its net assets…."
Not applicable	(B) "If the amount of the fund's illiquid investments that are assets is still above 15% of its net assets 30 days from the occurrence," then the board "must assess whether the plan presented to it…continues to be in the best interest of the fund or In-Kind ETF."
Not applicable	30b1-10 Report to SEC using Form N-LIQUID when a fund exceeds the 15% limit, and again when illiquid investments return to 15% or below.

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IN-KIND ETFs

- In-Kind ETFs are ETFs that primarily redeem in kind (other than a de minimus amount of cash) and publish portfolio holdings daily
- Must adopt tailored liquidity risk management program (including the additional factors that all ETFs must consider) and comply with the 15% illiquid investment limit
- In-Kind ETFs do not have to classify investments or comply with the highly liquid investment minimum requirement
- An In-Kind ETF must establish policies and procedures regarding how and when it will engage in redemptions in-kind

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BOARD RESPONSIBILITIES

- A fund's board (including a majority of independent directors) must:
  - Approve the written liquidity risk management program
  - Designate the investment adviser, officer, or officers ("program administrator") responsible for administrating the liquidity risk management program
  - Review a written report (at least annually) on the adequacy and effectiveness of the program and its implementation
  - Receive reports if a fund experiences a shortfall in its liquidity minimum or breaches the 15% limit on illiquid investments
  - Approve swing pricing (if the fund chooses to use swing pricing)

BOARD RESPONSIBILITIES

- A fund's board is not required to:
  - Approve the highly liquid investment minimum (unless the fund is below its minimum and seeks to change it)
  - Determine whether a specific security is liquid or illiquid

NEW DISCLOSURE REQUIREMENTS

- Form N-1A requires:
  - disclosure of the number of days in which the fund typically expects to pay redemption proceeds to redeeming shareholders
  - a description of a fund's procedures for redeeming shares and its methods for meeting redemption requests in stressed and non-stressed market conditions
- Form N-PORT requires:
  - non-public monthly reporting of the portfolio-level liquidity classifications and highly liquid investment minimum information
  - quarterly public reporting of the aggregate percentage of portfolio investments in each category and percentage of highly liquid investments segregated to cover, or pledged to satisfy margin requirements in connection with, certain derivatives transactions

NEW DISCLOSURE REQUIREMENTS

- New Form N-LIQUID requires non-public reporting if a fund's illiquid investments exceed 15% of net assets or if it experiences a shortfall of its liquidity minimum for more than 7 consecutive days
- Form N-CEN requires information on use of lines of credit, interfund borrowing and lending, swing pricing, self-identification as an In-Kind ETF

SWING PRICING RULE (RULE 22C-1(A)(3))

- This rule was separately adopted and permits a fund to adjust its NAV up or down on a given day to mitigate share dilution caused by heavy purchase and sale activity
- Pass on the costs of transaction activity to the transacting shareholders
- Swing Threshold: Level at which net purchases or redemptions exceed a specified NAV percentage, triggering the swing factor
- Swing Factor: Amount by which the NAV is adjusted once a fund has exceeded swing threshold (factor cannot exceed 2% of the fund's NAV)
- Available to funds two years after publication in Federal Register

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EXAMPLES OF SWING PRICING IN ACTION

- **Assume:**
  - Fund Assets: $100
  - NAV Per Share: $10.00
  - Swing Threshold: 2%
  - Swing Factor: 0.1%
- **Example #1**
  - Investor redemptions and purchases are predicted to result in a net flow of -$1
  - Result? *No swing* (net flow did not exceed $2), NAV per share $10.00

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EXAMPLES OF SWING PRICING IN ACTION

- **Example #2**
  - Investor redemptions and purchase are predicted to result in a net flow of -$3
  - Result? Swing NAV per share *downward* to $9.999 ($10.00 – ($10.00 x 0.001)), applied to transactions for *all investors*
- **Example #3**
  - Investor redemptions and purchases are predicted to result in a net flow of +$3
  - Result? Swing NAV per share *upward* to $10.01 ($10.00 + ($10.00 x 0.001)) applied to transactions for *all investors*

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