2016 INVESTMENT MANAGEMENT CONFERENCE

Registered Funds and Regulatory Developments

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Market Risk Disclosure Guidance

SEC GUIDANCE ON MARKET RISK DISCLOSURE, BACKGROUND

- Fund Disclosure Reflecting Risks Related to Current Market Conditions, IM Guidance Update No. 2016-02, March 2016
  - A mutual fund prospectus must summarize the fund's principal risks and the circumstances likely to negatively affect NAV, yield, and total return
  - The statutory prospectus must provide a fuller description of the fund's principal risks

PREVIOUS SEC RISK DISCLOSURE GUIDANCE

- Summary section should be concise
- Funds that expose investors to market, credit or other risks should consider changing names that suggest safety or protection from loss
- Funds that use derivatives should disclose volatility, leverage, liquidity, and counterparty risk
  - Derivatives disclosure should not be generic, but rather tailored to the derivatives in which the fund invests

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RISK DISCLOSURE RELATED TO CHANGING MARKET CONDITIONS

- Adviser should inform the fund board on process to evaluate risk disclosure and consider changes
- Market risk review process
  - **Monitor** market conditions and impact on fund risks
    - Considered part of prudent portfolio management
  - **Assess** if risks have been adequately communicated in light of current market conditions
  - **Communicate** changes to shareholders
    - Prospectus disclosure, shareholder reports, website disclosure, shareholder letters

EXAMPLES OF UPDATED MARKET RISK DISCLOSURE

- Fixed-income fund disclosure regarding interest rate, liquidity, and duration risk
  - **Interest Rates** — Current market conditions and potential changes in government policy may lead to increases in historically low interest rates
  - **Liquidity** — Increased redemptions in an increasing interest rate environment, and a reduction in market-making capacity may lead to liquidity issues
  - **Duration** — Longer-term securities are more sensitive to interest rate changes; numerical examples may help
- Exposure to Puerto Rico debt subject to heightened risk of default

Form N-PORT

CURRENT PORTFOLIO HOLDING DISCLOSURE REQUIREMENT

- Currently, a fund must file its complete schedule of investments four times each year:
  - As part of the fund's semiannual and annual shareholder reports
    - Filed on Form N-CSR within 10 days after delivery to shareholders, which is required within 60 days of period-end
  - After the end of the first and third fiscal quarters
    - Submitted as a public filing on Form N-Q within 60 days of period-end

PORTFOLIO HOLDING DISCLOSURE REQUIREMENT WITH NEW FORM N-PORT

- A fund will continue to file its complete schedule of investments twice each year with the semiannual and annual reports on Form N-CSR
- 30 days after the end of each month, a fund will be required to file a more detailed portfolio holdings report on Form N-PORT
  - Information on Form N-PORT (with certain exceptions) will be made publicly available 60 days after each fiscal quarter
- Form N-Q will be rescinded (1940 Act Rule 30b1-5 will be removed and reserved)

SEC RATIONALE FOR REQUIRING ADDITIONAL PORTFOLIO INFORMATION

- More frequent and timely portfolio information will assist the SEC's risk analysis and other oversight, policy formulation, disclosure review
  - E.g., portfolio data reported on Form N-MFP informed SEC money market fund reform
- Enable sophisticated institutional investors and third-parties that provide investor services to better analyze portfolio holdings (e.g., industry observers and academics)
  - Public availability of Form N-PORT information only quarterly, with a 60-day lag

FORM N-PORT COMPLIANCE DATES

- June 1, 2018, for fund complexes with net assets of $1 billion or more
- June 1, 2019, for fund complexes with net assets of less than $1 billion
  - Net assets measured as of the most recent fiscal year end
  - A fund's first reports on Form N-PORT, reflecting data as of June 30 of the applicable year must be filed no later than July 30 of that year

FORM N-PORT COVERED ENTITIES

- Per new 1940 Act Rule 30b1-9:
  - Registered open- and closed-end funds
    - But not money market funds or small business investment companies (SBICs)
  - ETFs organized as UITs

CONTENT OF FORM N-PORT

- Same disclosures as required by Form N-Q with the following new reporting requirements:
  - Controlled foreign corporations (CFCs) and their underlying investments
  - Amounts of certain liabilities:
    - Borrowings attributable to debt
    - Payables for delayed delivery, when-delivered, firm commitments, standby commitments, and liquidation preference for the fund's outstanding preferred

CONTENT OF FORM N-PORT (CONT'D)

- Funds with at least 25% notional debt exposure
  - Portfolio-level quantitative risk metrics that measure sensitivity to changes in interest rates, credit spreads, and asset prices
- Liquidity
  - Liquidity classification of each investment
  - Aggregate percentage of the portfolio invested in each of the liquidity categories
  - The highly liquid investment minimum

CONTENT OF FORM N-PORT (CONT'D)

- Derivatives
  - Detailed information about the characteristics and terms of each contract
  - Monthly net realized gain (loss) and net change in unrealized appreciation (depreciation)
    - Also reported for investments other than derivatives

CONTENT OF FORM N-PORT (CONT'D)

- Pricing and fund flows
  - Currently reported on Form N-SAR, but SEC believes monthly reporting is more helpful
  - Fund can use net sales/redemptions from omnibus accounts
- Securities lending
  - Transactions and counterparty exposures
  - Aggregate principal amount and aggregate value of each type of non-cash collateral received for loaned securities that is not treated as a fund asset

CONTENT OF FORM N-PORT (CONT'D)

- Monthly total returns for each of the preceding three months
- Certain information (i.e., nonpublic items or related explanatory notes) will not be made public even if included in public filings:
  - "Miscellaneous securities"
    - Up to 5%, held for less than 1 year prior to date of related balance sheet, and not previously publicly identified
  - Country of risk and economic exposure
  - Liquidity classification for portfolio investments
  - Highly liquid investment minimum
  - Delta for individual options, warrants, and convertibles

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CONTENT OF FORM N-PORT (CONT'D)

- A fund must report portfolio information on the same basis it uses to calculate NAV (i.e., T+1)
- A fund may use its own methodology and conventions of its service provider when responding to certain items on Form N-PORT
  - May require subjective judgments
  - Must be consistent with the way the fund reports internally and to current and prospective investors
    - Modeled after a similar instruction in Form P-F

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FORM N-PORT FILING REQUIREMENTS, FORM N-CSR CERTIFICATIONS

- Filing — Electronically filed in a structured data format, extensible markup language (XML) on EDGAR
- Form N-CSR certification
  - Principal executive and financial officers must certify
    - The accuracy of information reported to the SEC, and
    - Disclosure controls and procedures and internal control over financial reporting during the most recent fiscal half-year
      - Currently, funds certify only as to the second quarter in the period covered by the report
  - Rescinds certifications required on Form N-Q

SEC Liquidity Risk - Final Rule 22e-4

LIQUIDITY RISK MANAGEMENT PROGRAM (LRMP)

- Funds must establish a written LRMP- approved by Board, reviewed annually, to consider the following factors:
  - Investment strategy and liquidity of portfolio investments during both normal and reasonably foreseeable stressed conditions
    - Whether strategy is appropriate for open-end fund
    - Extent to which strategy involves a relatively concentrated portfolio or large positions in particular issuers
    - Use of borrowings for investment purposes and derivatives
  - Short-term and long-term cash flow projections during both normal and reasonably foreseeable stressed conditions
  - Holdings of cash and cash-equivalents, as well as borrowing arrangements and other funding sources
- Proposed vs Final Rule – proposed rule required periodic review; final rule requires at least annual review

LIQUIDITY RISK DEFINITION

- "[T]he 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*"
- "Significant dilution" – used to clarify that slight NAV movements are not implicated, but shareholder dilution is the focus
  - Staff noted such dilution can occur at levels much lower than a "fire sale situation"
- Funds must classify liquidity of portfolio investments
- In-Kind ETFs are exempt
- Proposed vs Final Rule – proposed definition used term "*materially affecting the fund's NAV,*" rather than "*significant dilution of remaining investors' interests in the fund*"

LIQUIDITY CATEGORIES- FINAL RULE

- **Highly liquid investments** –
  - any investment reasonably expected to be ***convertible to cash*** in current market conditions ***in three business days*** (or less) without a significant change to its market value
- **Moderately liquid investments** –
  - any investment reasonably expected to be ***convertible to cash*** in current market conditions ***in more than three calendar days but in seven calendar days or less*** without a significant change to its market value
- **Less liquid investments** –
  - any investment reasonably expected to be ***sold or disposed of*** in current market conditions ***in seven calendar days or less*** without a significant change to its market value, but where the sale or disposition is reasonably expected to ***settle in more than seven calendar days***
- **Illiquid investments** –
  - any investment that ***may not reasonably be expected to be sold or disposed of*** in current market conditions ***in seven calendar days or less*** without a significant change in the market value of the investment
- Based on an analysis of market, trading and investment-specific considerations
- Liquidity classifications are to be based on *current market conditions*
- Funds may *classify* the liquidity of portfolio investments by *asset class*
- Classifications must be reviewed at least monthly, or more frequently

LIQUIDITY CLASSIFICATIONS- PROPOSED RULE

- Proposed rule had six, rather than four, categories
- Included a list of nine factors to consider, which was replaced by the analysis of market, trading and investment-specific factors
- Only permitted liquidity review by position, rather than asset class
- Required ongoing liquidity classifications review, rather than monthly

HIGHLY LIQUID INVESTMENT MINIMUM (HLIM)

- Fund must establish a HLIM
  - Funds investing primarily in highly liquid investments do not need an HLIM
  - Defined as in the liquidity categories above
  - “Highly liquid investments” are defined as any investment reasonably expected to be convertible to cash in current market conditions in three business days (or less) without a significant change to its market value
  - Based on standard settlement cycle of T+2
- HLIM must be determined based on an analysis of LRMP factors discussed above
- HLIM set based on normal market conditions and during stressed conditions reasonably foreseeable during the period until next review (e.g., one year)
- Proposed vs Final Rule –
  - Proposed rule changed from 3-day liquid assets minimum to HLIM
  - Proposed limits on acquiring non-highly liquid assets when below minimum relaxed in final rule

15% ILLIQUID INVESTMENTS MAXIMUM

- 15% illiquid investment maximum
  - Defined as in the liquidity categories above
  - "Illiquid investments" are defined as any investment that may not reasonably be expected to be sold or disposed of in current market conditions in seven calendar days or less without a significant change in the market value of the investment
- Applies to funds and In-Kind ETFs
- Proposed vs Final Rule –
  - Proposed rule required divesture of investments when above 15%
  - Final rule limits acquisition of illiquid investments when above 15% and replaces prior SEC guidance with rule

IN-KIND ETFs

- Defined as an ETF that meets redemptions through in-kind transfers of securities, positions, and assets other than a *de minimis* amount of cash, that publishes its portfolio holdings daily
- Must adopt a LRMP:
  - Must analyze liquidity under LRMP
  - Not required to classify assets in 4 categories
- Tailored LRMP requirements:
  - Liquidity risks and needs must be periodically assessed
  - Relationship between ETF's portfolio liquidity and pricing and spreads of trading, including efficiency of arbitrage function
  - Effect of composition of baskets on overall liquidity of ETF's portfolio
- Not required to have HLIM
- Subject to 15% illiquid maximum
- Proposed vs Final Rule –
  - Proposed rule did not include HLIM and classifications exemptions
  - Proposed rule did not include tailored LRMP requirements

BOARD APPROVAL AND DESIGNATION OF RESPONSIBILITIES- FINAL RULE

- A fund's board (including majority of independent trustees) must *approve*:
  - The written LRMP (including a majority of independent trustees)
  - The investment adviser or officer(s) responsible for administering the LRMP
- A fund's board must *review*:
  - At least annually, a written report of the LRMP's adequacy and effectiveness
  - Initial LRMP approval may be done by review of a summary of the LRMP
  - Material changes to the LRMP

BOARD APPROVAL (CONT.)

- A fund must report to the board:
  - When it falls below its highly liquid investment minimum:
    - At the next regular board meeting, if the below the minimum for less than 7 calendar days
    - Within 1 business day, if below the minimum for more than 7 calendar days
  - When it exceeds 15% illiquid holdings:
    - Within 1 business day
    - With an explanation of extent and causes, and how fund plans to bring illiquid level back to or below 15%

BOARD APPROVAL AND DESIGNATION OF RESPONSIBILITIES- PROPOSED VS. FINAL RULE

- Proposed Rule
  - A fund's board is required to approve the fund's HLIM
  - A fund's board is required to approve material changes to the LMRP
- Final Rule
  - A fund's board is not required to approve the fund's HLIM
    - Unless a fund attempts to change it when it is below its minimum
  - A fund's board is not required to approve material changes to LRMP

LIQUIDITY RISK FINAL RULE - KEY DATES (COMPLEXES WITH GREATER THAN $1B)

- Adopted October 13, 2016
- June 1, 2017
  - N-1A disclosure, including disclosure of redemption methods
- December 1, 2018
  - Adoption of written LRMP (in form approved by the Board); reporting under Forms N-PORT and N-CEN begin
- January 31, 2019
  - First Form N-PORT filing with liquidity information from period-ending 12/31/18

Questions?