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SEC Approves New Liquidity Risk Management and Swing Pricing Rules for Certain Open-End Funds

This publication provides more detailed information about the new SEC rules we first described in our publication issued on October 14, 2016 right after they were approved.

By The Investment Management Practice

I. Introduction

On October 13, 2016, the Securities and Exchange Commission ("SEC") unanimously approved a set of broad and sweeping rules aimed at enhancing liquidity risk management by open-end mutual funds and exchange-traded funds ("ETFs") (collectively the "Liquidity Rules"). In approving the Liquidity Rules, SEC Chair Mary Jo White noted that it is imperative that open-end mutual funds and ETFs manage their liquidity carefully, both to ensure that redemptions can be fulfilled in a timely manner[1] and to minimize the impact of redemptions on remaining investors and on the broader marketplace. She also noted that the recent growth of certain less liquid strategies has made the effective management of fund liquidity more important than ever, for both investors and the markets in general.

Under the Liquidity Rules, funds will be required to establish liquidity risk management programs ("LRMPs"): LRMPs will require, among other things: (1) broad oversight of the program; (2) classification of the liquidity of each of the fund's portfolio investments (including each of the fund's derivative transactions); and (3) assessment, management, and periodic review of a fund's liquidity risk. In addition, as part of an LRMP, a fund will need to maintain a minimum percentage in "highly liquid investments", as defined below.

In addition to adopting the Liquidity Rules, in an effort to reduce the potential dilution that non-redeeming fund shareholders may experience during heightened fund flows, the SEC adopted a rule that will permit, but not require, open-end funds (but not money market funds or ETFs) to employ "swing pricing," a process whereby a fund's net asset value is adjusted, up or down, in order to pass on the trading costs associated with trading portfolio holdings needed as a result of purchasing or redeeming shareholders.

Most funds will be required to comply with the liquidity risk management program requirements by December 1, 2018, while funds with less than $1 billion in net assets will be required to do so by June 1, 2019. The SEC is delaying the effective date of the amendments that would permit funds to

use swing pricing in order to allow the industry to create operational solutions in an efficient manner. The swing pricing rules will become effective 24 months after publication in the Federal Register.

II. Liquidity Risk Management Program

A. Overview

New Rule 22e-4 will require registered open-end funds, including In-Kind ETFs[2] but excluding money market funds, to establish a written LRMP in order to assess and manage a 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 without significant dilution of remaining investors' interests in the fund.[3]

A fund's LRMP must include policies and procedures that are reasonably designed to incorporate the items below:

1. *Assessment, Management, and Periodic Review of Liquidity Risk*. Each fund and In-Kind ETF must assess, manage, and periodically review (no less than annually) its liquidity risk.

2. *Classification*. Each fund must classify each of the fund's portfolio investments (including derivatives transactions) into one of four categories, as discussed further below. A fund must review its portfolio investments' classifications, at least monthly in connection with reporting the liquidity classification for each portfolio investment on Form N-PORT, and more frequently if changes in relevant market, trading, and investment-specific considerations are reasonably expected to materially affect one or more of its investments' classifications.

3. *Highly Liquid Investment Minimum*. This is the percentage of the fund's assets maintained in highly liquid investments that are assets.[4] Funds will be required to report their highly liquid investment minimum on Form N-PORT.

4. *Limitation on Illiquid Investments*. No fund or In-Kind ETF may acquire any illiquid investment, as defined below, if, immediately after the acquisition, the fund or In-Kind ETF would have invested more than 15 percent of its net assets in illiquid investments that are assets.

5. *Redemptions In-Kind*. A fund that engages in, or reserves the right to engage in, redemptions in-kind and any In-Kind ETF must establish policies and procedures regarding how and when it will engage in redemptions in-kind.

Each of the abovementioned items is discussed in greater detail below.

B. Assessment and Management of a Fund's Liquidity Risk

The Liquidity Rules will require a fund to assess, manage, and periodically review, at least annually, its liquidity risk considering the following factors, as applicable:

- The fund or In-Kind ETF'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,[5] 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;[6]

- 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;[7] and
- For an ETF: (i) The relationship between the ETF's portfolio liquidity and the way in which, and the prices and spreads at which, 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.

In the Adopting Release, the SEC also noted that some funds may consider employing cross-trades as a liquidity risk management tool. The SEC went on to note that "less liquid assets are less likely to satisfy Rule 17a-7 than highly liquid investments."[8] As a result, the SEC believes that any assets used in a cross-trade should be analyzed to ensure that the requirements of Rule 17a-7 are met. Finally, the SEC noted that a fund's Rule 17a-7 policies and procedures would likely need to be designed to address how a fund would determine that cross-trading a less liquid security is consistent with requirements of Rule 17a-7.[9]

C. Classification and Monitoring of Portfolio Assets

Under the new Rule 22e-4, a fund[10] will be required to classify each of its portfolio investments (including each of the fund's derivative transactions) into four liquidity categories. When classifying investments, a fund will be required to use information obtained after reasonable inquiry taking into account certain market, trading, and investment considerations.[11] The four liquidity classifications are:

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

In classifying its investments, a fund may classify and review its investments (including derivatives), based on their asset class, instead of classifying and reviewing each investment individually. However, the new rules require that a fund assess whether any individual investment within an asset class has investment-specific concerns. While thhe SEC did not adopt the proposed nine separate factors that a

fund would be specifically required to consider when classifying and reviewing the liquidity of its portfolio assets,[12] the new rules do provide that when a fund is classifying its investments, it:

- Determine whether trading varying portions of a position in a particular portfolio investment or asset class, in sizes that the fund could reasonably anticipate trading, is reasonably expected to significantly affect its liquidity, and if so, the fund must take this determination into account when classifying the liquidity of that investment or asset class;
- Identify the percentage of a fund's highly liquid investments that the fund has segregated to cover, or pledge to satisfy margin requirements in connection with derivatives transactions that the fund has classified as moderately liquid investments, less liquid investments, and illiquid investments; and
- Consider information about any market trading or investment-specific considerations that are reasonably expected to significantly affect the liquidity characteristics of a specific investment, as compared to the fund's other portfolio holdings within that asset class.

In the Adopting Release, the SEC noted that to the extent a fund is not currently taking into consideration the above mentioned factors, the new rules could result in a fund deeming a greater portion of its investments as illiquid. In extreme circumstances, this may cause a fund to modify its investment strategy or reconsider its structure as an open-end fund.

D. Highly Liquid Investment Minimum

Generally, a fund that does not primarily hold assets that are highly liquid investments must determine its "highly liquid investment minimum," or the minimum amount of the fund's net assets that the fund invests in highly liquid investments. Specifically, each fund must:

- Determine a highly liquid investment minimum, considering the factors specified in the new rule. See discussion in II.C of this Client Alert. The highly liquid investment minimum may be changed at any time except during any period of time that a fund's highly liquid investments fall below the determined minimum. In this case, the minimum may only be changed if a fund's board of directors, including a majority of directors who are not interested persons of the fund approve the change. Board responsibilities are discussed in greater detail in Section II.G of this Client Alert;
- Periodically review, no less frequently than annually, the highly liquid investment minimum; and
- Adopt and implement policies and procedures for responding to a shortfall in a fund's highly liquid investments below its highly liquid investment minimum.[13]

E. 15 Percent Illiquid Limit

The final rule replaces historical SEC guidance regarding limiting investment in illiquid securities with a new rule that prohibits a fund or In-Kind ETF (excluding UITs and money market funds) from acquiring any illiquid investment if, immediately after the acquisition, the fund would have invested more than 15 percent of its net assets in illiquid investments that are assets. In the Proposing Release, the SEC requested comment on whether the SEC should require a fund to divest its assets in excess of the 15 percent limit or place a time limit on the time a fund can exceed the 15 percent limit. In the Adopting Release, the SEC specified that a fund will be prohibited from acquiring any illiquid

investment if, immediately after the acquisition, its illiquid investments that are assets would exceed 15 percent of its net assets.

In the Adopting Release, the SEC noted that if a fund's illiquid investments exceed the 15 percent limit it could indicate that the fund is encountering harmful liquidity pressures. Thus, the new rules will require that a fund promptly report such an occurrence to its board and the SEC. Specifically, a fund that holds more than 15 percent of its net assets in illiquid investments that are assets will be required to report such an occurrence to its board of directors within one business day, including an explanation of the extent and causes of the occurrence and how it plans to bring its illiquid investments that are assets to or below 15 percent of its net assets within a reasonable period of time.

If the amount of the fund's illiquid investments that are assets is still above 15 percent of its net assets 30 days from the occurrence (and at each consecutive 30-day period thereafter), the board of directors, including a majority of its independent directors, must assess whether the plan presented to them continues to be in the best interest of the fund. In addition, a fund would be required to report breaks in the 15 percent limit to the SEC on the new Form N-LIQUID.

F. Redemptions In-Kind

Like the Proposing Release, under the final rules, a fund that engages in redemptions in-kind will be required to establish policies and procedures regarding how and when the fund will engage in redemptions in-kind. The SEC noted that such policies and procedures generally should address the process for redeeming in-kind, as well as the circumstances under which the fund would consider redeeming in-kind.

G. Role of the Board

Under the new rules, a fund's board of directors will be required to approve the designation of the fund's investment adviser, officer, or officers responsible for administering the fund's liquidity risk management program. It is important to note, however, that while portfolio managers of the fund cannot be the sole persons designated to administer the program, portfolio managers may be a part of any committee or group designated to administer the program, only if more than one person is so designated. A fund's board will not be required to specifically approve the fund's highly liquid investment minimum or to approve material changes to the LRMP. However, the board, including a majority of its independent directors, will be required to provide initial approval of a fund's liquidity risk management program and review a written report, at least annually, on the adequacy of the fund's LRMP, including its highly liquid investment minimum and the effectiveness of its implementation. Additionally, the new rules did not change the Proposing Release's requirement that a fund's board oversee any liquidity risk monitoring or risk management activities undertaken by the fund's service providers.

H. Recordkeeping

To assist the SEC in identifying weakness in a fund's liquidity risk management, the Liquidity Rules require each fund to maintain a written copy of the policies and procedures adopted as part of its liquidity risk management program for five years, in an easily accessible place. Additionally, each fund will be required to maintain copies of any materials provided to its board in connection with the board's initial approval of the fund's LRMP, and copies of written reports provided to the board on the adequacy of the fund's liquidity risk management program, including the fund's highly liquid investment minimum, and the effectiveness of its implementation for at least five years after the end

of the fiscal year in which the documents were provided to the board, the first two years in an easily accessible place.

I. Unit Investment Trusts

In addition to covering funds and ETFs, the Liquidity Rules also include a separate limited liquidity review applicable to unit investment trusts ("UITs"). Under the final rules, the UIT's principal underwriter or depositor must determine, on or before the initial deposit of portfolio securities into the UIT, that the portion of the illiquid investments that the UIT holds or will hold at the date of deposit that are assets is consistent with the redeemable nature of the securities it issues. The rule also requires UITs to maintain a record of that determination for the life of the UIT and for five years thereafter. UITs and their principal underwriters and depositors are not subject to any of the rule's other liquidity risk management program requirements.

III. Swing Pricing

Rule 22c-1(a)(3), which permits, but does not require, the use of swing pricing, is focused on mitigating shareholder dilution that might result from unexpected redemptions or subscriptions into a fund. Swing pricing will permit a fund to adjust its NAV up or down in the event that net purchases or redemptions exceed a specified percentage of the fund's NAV on any given day, known as the "swing threshold." During periods of relatively high net purchases or net redemptions, the use of swing pricing will allow the costs resulting from such activity to be reflected immediately in a fund's NAV, thereby passing on the costs stemming from shareholder purchase or redemption activity to all shareholders, including those associated with that activity. The goal of swing pricing is to mitigate dilution to those shareholders that were not involved in the subscription or redemption activity.

In order for a fund to employ swing pricing, the fund's board will be required to adopt and approve policies and procedures specifying the swing threshold and method of determining the swing factor,[14] with such policies and procedures further providing that the fund must adjust its NAV by the swing factor once net purchases or net redemptions exceed the specified swing threshold.[15] Further, adopted policies and procedures must provide for the periodic review of its swing threshold, no less frequently than annually.

A. Swing Threshold

A fund's swing threshold should represent a level beyond which net purchases or net redemptions will trigger portfolio trading activity that may generate material liquidity or transaction costs for the fund. Accordingly, Rule 22c-1(a)(3)(i)(B) requires that a fund must consider a set of factors in order to determine the fund's swing threshold, which include:

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;

3. The fund's holdings of cash and cash equivalents, as well as borrowing arrangements and other funding sources; and

4. The costs associated with transactions in the markets in which the fund invests.

While the first three factors focus primarily upon liquidity elements, the fourth factor allows a fund to consider a range of costs that may be attributable to trading activity specific to the fund. In considering this factor, a fund may take into account, as applicable, market impact costs, spread costs, transaction fees such as brokerage and custody fees, as well as other charges, fees, and taxes resulting from the purchase or sale of securities following fund share purchases or redemptions.

B. Swing Factor

Swing pricing will be a tool for funds with the aim to prevent the dilution of interest to the non-redeeming investors. A fund's swing pricing policies and procedures would have to specify the process for how the fund's swing factor and swing threshold would be determined (taking into account certain considerations) and establish and disclose an upper limit on the swing factor used, which may not exceed two percent of net asset value per share.

Unlike the swing threshold, the exact percentage of which is specified in the adopted policies and procedures, the amount of the swing factor may vary from one day to the next. In effect, the swing factor will vary depending on the facts and circumstances taken into consideration in accordance with the prescribed factors.

IV. Disclosure Amendments and Reporting Related to the Liquidity Rules

In connection with the Liquidity Rules, the SEC has required that funds report the necessary information on various new forms which the SEC adopted simultaneously with the Liquidity Rules. Each of the new Forms is discussed in greater detail in our Client Alert entitled SEC Approves New Modernization Rules to Enhance Reporting By Investment Companies.

A copy of the SEC's final rule may be found here.

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If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

Los Angeles

Yousuf I. Dhamee
1.213.683.6179
yousufdhamee@paulhastings.com

Arthur L. Zwickel
1.213.683.6161
artzwickel@paulhastings.com

New York

Tram N. Nguyen
1.212.318.6848
tramnguyen@paulhastings.com

Michael R. Rosella
1.212.318.6800
mikerosella@paulhastings.com

Vadim Avdeychik
1.212.318.6054
vadimavdeychik@paulhastings.com

Jacqueline A. May
1.212.318.6282
jacquelinemay@paulhastings.com

Gary D. Rawitz
1.212.318.6877
garyrawitz@paulhastings.com

Bill Belitsky
1.212.318.6097
billbelitsky@paulhastings.com

San Francisco

David A. Hearth
1.415.856.7007
davidhearth@paulhastings.com

Washington, D.C.

Wendell M. Faria
1.202.551.1758
wendellfaria@paulhastings.com

[1] For application to Unit Investment Trusts, see page 6 herein.

[2] An In-Kind ETF is an exchange traded fund that meets redemptions through in-kind transfers of securities, positions, and assets, other than a *de minimis* amount of cash. *See* Rule 22e-4(a)(9).

[3] *See* 22e-4(a)(11). This definition is a change from the Proposing Release, which referred to a material change in a fund's net asset value. However, in the Adopting Release the SEC noted that impacts on "valuation may play a significant role in evaluating the ability to effectively meet shareholder redemptions" and "inclusion of a conceptual relationship between liquidity and sale price in the definition of liquidity risk is appropriate." *See* "Investment Company Liquidity Risk Management Programs" (October 13, 2016), available at https://www.sec.gov/rules/final/2016/33-10233.pdf (the "Adopting Release"); *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 https://www.sec.gov/rules/proposed/2015/33-9922.pdf (the "Proposing Release").

[4] Rule 22e-4(a)(7) refers to highly liquid investments that are "assets" to make clear that when evaluating whether a fund is meeting its highly liquid investment minimum, the fund should look to its investments with positive values.

[5] In the Adopting Release, the SEC noted that certain funds that have significant holdings of securities with extended settlement periods may face challenges operating as an open-end fund and should take this into account when determining whether a fund's portfolio is appropriate in an open-end fund structure.

[6] In the Adopting Release, the SEC noted that when a fund files its initial registration statement and post-effective amendments thereto with the SEC's Division of Investment Management for review, SEC staff could request information from the fund regarding the fund's basis for determining that its investment strategy is appropriate for the open-end structure, just as staff currently may request information from a fund to support its disclosure reflecting the fund's compliance with various provisions of the Investment Company Act of 1940 and rules thereunder.

[7] With respect to borrowing arrangements, the SEC did note that a fund must consider the "likely overall benefits and risk in including such borrowing within a liquidity risk management program."

[8] See page 295 of the Adopting Release.

[9] See page 247 of the Adopting Release.

[10] Under the new rules, In-Kind ETFs are not expected to classify their portfolio investments or comply with the highly liquid investment minimum requirement.

[11] In the Adopting Release, the SEC noted that when classifying its investments, the SEC does not expect a fund to predict how an investment may trade in stressed market conditions, as that "would introduce an additional layer of subjectivity into the classification process." However, it is important to contrast this with rule text and the Adopting Release where the SEC noted that a fund would be required to review its liquidity classifications monthly or more frequently if changes in the market conditions are reasonably expected to affect the liquidity classifications. *See* Rule 22e-4(b)(1)(ii).

[12] The SEC noted in the Adopting Release that even though the nine specific factors were not being adopted in the final rules, the proposed nine classification factors could help a fund in evaluating relevant market, trading, and investment specific considerations.

[13] To the extent a shortfall in the highly liquid investment minimum lasts for more than seven consecutive calendar days, the investment adviser, officer, or officers responsible for administering the fund's LRMP must report to the board within one business day after the shortfall, with an explanation of how the fund will restore the minimum within a reasonable period of time.

[14] The fund's policies and procedures will be required to specify whether the swing factor would be subject to any upper limit, but no more than 2%.

[15] In deciding whether the swing threshold has been exceeded on a particular business day, the appropriate administrator is permitted to make this determination based upon information obtained after reasonable inquiry, and must exclude redemptions made in-kind when making its determination.