CLIENT MEMORANDUM

SEC Proposes Changes to Open-End Funds Related to Management of Liquidity Risk

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AUTHORS

P. Georgia Bullitt | James R. Burns | Rose F. DiMartino | Benjamin J. Haskin | James W. Hahn

On September 22, 2015, the Securities and Exchange Commission (the "SEC") unanimously approved the proposal of a new rule and amendments to other rules and forms[1] under the Investment Company Act of 1940 (the "Investment Company Act"). The proposed changes are designed to promote effective liquidity risk management by funds, enhance disclosure regarding liquidity practices for investors, and address the effects of fund investment activities on investors and on the financial markets.[2] The changes are the second in a series of five initiatives that the SEC is developing to improve oversight of the asset management industry.

The proposal follows an outreach initiative by the SEC to fund complexes regarding their liquidity risk management practices. The SEC noted that it has been over 20 years since it provided guidance regarding the liquidity of non-money market, open-end funds and, during the time period, the U.S. fund industry has experienced significant growth of investment vehicles following fixed income and alternative investment strategies that include less liquid asset classes.

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1 *See* Open-End Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release, Investment Company Act Release No. 31835 (Sept. 22, 2015), *available* here (the "Proposing Release").

2 *See* Speech, Mary Jo White, "Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry," The *New York Times* DealBook Opportunities for Tomorrow Conference Held at One World Trade Center, New York, N.Y. (Dec. 11, 2014), *available* here.

The SEC also noted that practices among fund complexes vary considerably, and it expressed concern that some funds may not employ adequate liquidity risk management practices.

The multi-layered set of changes, if adopted as proposed, would require significant compliance oversight and potentially change the way open-end funds investing in certain asset classes are currently managed—even for those fund complexes that already have comprehensive liquidity management programs. The new measures would require monitoring and approval by fund boards and, because they require several subjective determinations to be made, they pose the risk of increased litigation and enforcement exposure for management and fund directors.

Under the proposal, open-end funds would be required, among other things, to adopt liquidity risk management programs, maintain a fixed portion of each fund's portfolio assets in assets that could be liquidated within three business days, and classify all fund assets within six liquidity buckets. The proposed rule would require a fund to review the liquidity classification of each of the fund's portfolio positions on an ongoing basis. This review would require the fund to determine whether, in light of current circumstances, an adequate level of liquidity is being maintained, and would require monitoring both of position-level classifications as well as a holistic review of the portfolio. The proposal would also codify the staff's existing liquidity guidance, which restricts a fund from investing more than 15% of its assets in instruments that the fund does not believe can be liquidated at the asset's value within seven days. The SEC provided different definitions of liquidity for purposes of classification within the six buckets and calculation of the 15% limit. The proposed asset classifications, for example, would require not only evaluating whether a contract of sale could be entered into for an instrument within a given period (*e.g.*, within seven days) but also whether receipt of the proceeds from the sale could be obtained during that time period.[3] The 15% limit (the "15% standard asset" illiquidity limit), on the other hand, would not require a fund to take into account receipt of proceeds of any sale. Consequently, as is done currently, a fund could consider a security to be liquid if it can be sold within seven days at approximately its carrying value, even if it settled beyond that seven-day period.

In addition, mutual funds (but not exchange-traded funds ("ETFs") or money market funds) would have the option to engage in "swing pricing," which is designed to protect shareholders from dilution arising from costs associated with large subscription or redemption activity. Swing pricing allows a fund to adjust NAV to effectively pass on the market impact costs, spread costs, and transaction fees and charges stemming from flows into or out of the fund to shareholders associated with that activity. Although swing pricing has been used by European funds it has not been authorized to date in the U.S. and the proposal would require Rule 22c-1 to be amended to accommodate the change. Funds would be able to implement swing pricing immediately on a voluntarily basis following the adoption of the rule change.

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[3] This could potentially result in a very high percentage of funds that hold loan interests having to classify those assets in the longer liquidity classification buckets since those instruments typically settle over extended periods.

Comments on the proposed new rule and amendments are due 90 days after publication of the proposing release (the "Proposing Release") in the Federal Register. The new rule and amendments would also have a staged compliance period for fund complexes with less than $1 billion in net assets.

I. Liquidity Risk Management Programs

Proposed Rule 22e-4 would require each registered open-end management investment company, including ETFs but not including money market funds, to establish a written liquidity risk management program designed to assess and manage the fund's liquidity risk.[4] As part of the program, each fund would be required to appoint the fund's investment adviser or officers -- which may not be solely portfolio managers of the fund – to administer the program and to prepare an annual report for the fund's board regarding liquidity risk. A fund's board, including a majority of independent directors, would be required to approve the fund's liquidity risk management program, any material changes to the program, and the fund's designation of those responsible for administering the program.[5] The liquidity risk management program would require:

- Classification into one of six liquidity buckets, and ongoing review of the classification, for all portfolio assets held by a fund;
- assessment and periodic review of each fund's liquidity risk and portfolio classifications; and
- management of the fund's liquidity risk, including maintenance of an established minimum cushion of the fund that is invested exclusively in assets that are convertible to cash within three business days at a price that does not materially affect the value of the asset immediately prior to sale.[6]

Under the proposal, liquidity risk would be defined as the risk that a fund would be unable to meet redemption requests under normal conditions or under stressed conditions, if reasonably foreseeable, without materially affecting the fund's net asset value ("NAV").[7]

Proposed Rule 22e-4 would also codify the 15% limit on "illiquid" assets included in current SEC guidelines (the "15% guideline").[8] The 15% guideline limits open-end funds to holding no more than 15% of total assets in assets deemed to

[4] Proposing Release, at 44. Each series of an open-end fund would be responsible for developing a liquidity risk management program tailored to its own liquidity risk in order to comply with the proposed rule. *See* Proposed Rule 22e-4(a)(5).

[5] Proposed Rule 22e-4(b)(3).

[6] *See* Proposed Rule 22e-4(b)(1), (2).

[7] Proposed Rule 22e-4(a)(7).

[8] Revisions of Guidelines to Form N-1A, Investment Company Act Release No. 18612 (Mar. 12, 1992), at section III ("If an open-end company holds a material percentage of its assets in securities or other assets for which there is no established market, there may be a question concerning the ability of the fund to make payment within seven days of the date its shares are tendered for redemption. The usual limit on aggregate holdings by

be illiquid and provides that a portfolio security or other asset will be considered illiquid if it cannot be sold or disposed of in the ordinary course of business within seven days[9] at approximately the value at which the fund valued the investment. The 15% guideline would continue to be required *in addition to* the new asset classification process.

Liquidity Classification Categories. Under the proposed rule, each fund would be required to classify and engage in an ongoing review of its positions in a portfolio asset (or portions of a position in a particular asset) based on the number of days in which it is determined, using information obtained after reasonable inquiry, that the fund's position in the asset (or portion of a position) would be convertible to cash[10] at a price that does not materially affect the value of that asset immediately prior to sale.[11] The fund would be required to classify each asset position (or portion of a position) into one of six liquidity categories that would be convertible to cash within a specified number of days. The classification buckets are: one business day; 2-3 business days; 4-7 calendar days; 8-15 calendar days; 16-30 calendar days; and more than 30 calendar days.[12]

In the SEC's view, this "spectrum-based" approach, as opposed to the binary determination of whether an asset is liquid or illiquid under the 15% guideline, would be more nuanced and could enhance a fund's ability to construct a portfolio whose liquidity profile is calibrated to reflect the fund's specific liquidity needs.[13] Significant questions exist as to whether this approach is needlessly complex and ignores the subjective judgment required to determine which category a security fits within.

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an open-end investment company of illiquid assets is 15% of its net assets. An illiquid asset is any asset which may not be sold or disposed of in the ordinary course of business within seven days at approximately the value at which the mutual fund has valued the investment.").

[9] Section 22(e) of the Investment Company Act provides that no open-end 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 absent specified unusual circumstances. In addition to the seven-day redemption requirement in section 22(e), Rule 15c6-1 under the Securities Exchange Act of 1934 also impacts the timing of open-end fund redemptions because the rule requires broker-dealers to settle securities transactions, including transactions in open-end fund shares, within three business days after the trade date. Proposing Release, at 44.

[10] *See* Proposed Rule 22e-4(a)(3) (defining "convertible to cash" as "the ability to be sold, with the sale settled").

[11] Proposed Rule 22e-4(b)(2)(i). With respect to this determination, the term "immediately prior to sale" is meant to reflect that the fund must determine whether the sales price 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. The term "immediately prior to sale" is not meant to require a fund to anticipate and determine in advance the precise current market price or fair value of an asset at the moment before the fund would sell the asset. Proposing Release, at 64.

[12] Proposed Rule 22e-4(b)(2)(i)(A)-(F).

[13] *See* Proposing Release, at 70.

Liquidity Classification Factors. Funds would be required to take the following factors into account, to the extent applicable, when classifying the liquidity of each portfolio position in a particular asset:

- Existence of an active market for the asset, including whether the asset is listed on an exchange, as well as the number, diversity, and quality of market participants;
- Frequency of trades or quotes for the asset and average daily trading volume of the asset (regardless of whether the asset is a security traded on an exchange);
- Volatility of trading prices for the asset;
- Bid-ask spreads for the asset;
- Whether the asset has a relatively standardized and simple structure;
- For fixed income securities, maturity and date of issue;
- Restrictions on trading of the asset and limitations on transfer of the asset;
- The size of the fund's position in the asset relative to the asset's average daily trading volume and, as applicable, the number of units of the asset outstanding; and
- Relationship of the asset to another portfolio asset.[14]

The analysis must be conducted fund-by fund, and the Proposing Release envisions that the same security could be in different liquidity buckets for different funds in a complex and that large positions could be divided into portions and allocated among the buckets. The Proposing Release notes that this list is not meant to be exhaustive and that the factors are a minimum set of considerations to be used in classifying the liquidity of each portfolio position.[15]

Ongoing Review. The proposed new rule would require a fund to classify and engage in an ongoing review of each of the fund's positions in a portfolio asset (or portions of a position in a particular asset). While the SEC acknowledges that a fund should monitor the liquidity of its portfolio holistically, the rule would require position-level liquidity classification on an ongoing basis in order, in the SEC's view, to reduce the risk that the fund would be unable to meet its redemption obligations and reduce potential dilution of shareholders' interests. In adopting ongoing review policies and procedures, the SEC indicated that funds should explain how they would identify market-wide developments and security- and asset-

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[14] Proposed Rule 22e-4(b)(ii)(A)-(I).

[15] Proposing Release, at 81.

class-specific developments, which demonstrate a need to change a liquidity classification.[16] The Proposing Release suggests that the frequency of the "ongoing" review can vary by asset, with the appropriate time period for the review being daily or even hourly for highly volatile instruments.

One of the more challenging aspects of the proposal is the requirement that funds evaluate liquidity in light of the fund's shareholder base. The fund would be expected to project anticipated redemptions in light of shareholder "concentration," historical redemption patterns (such as year-end tax selling), investment strategy and extraordinary events, such as the departure of a portfolio manager. Given the relatively non-transparent manner in which mutual fund shares are typically held (*e.g.*, through 401(k) plans, platform intermediaries or other third-party intermediaries), it may not be practical for a fund to obtain the detailed "know-your-shareholder" information the proposed new rule suggests be taken into account.

Assessment and Management of a Fund's Liquidity Risk. Proposed new Rule 22e-4 would also require a fund to assess and periodically review its liquidity risk, taking into account the following 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 (*e.g.*, a fund's policy of providing redemption proceeds within one day);
  - 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 borrowings and derivatives for investment purposes; and
- Holdings of cash and cash equivalents, as well as borrowing arrangements and other funding sources.[17]

Similar to the liquidity classification factors noted above, this list of factors to assess liquidity risk (the "Liquidity Risk Factors") is not exhaustive. However, a fund would be required to consider these factors, as applicable, as a minimum set of considerations to be used to assess and periodically review a fund's liquidity.

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[16] Proposing Release, at 101-02.

[17] Proposed Rule 22e-4(b)(2)(iii)(A)-(D).

In connection with the evaluation of liquidity risk, the SEC reminded funds that segregated assets held against derivatives and borrowings, as provided in Investment Company Act Release No. 10666,[18] would be considered to be unavailable for sale or disposition, including for redemption. As a result, these assets would generally assume the same liquidity profile as the derivative. Because of this, investments in derivatives, particularly those requiring segregation of assets equal to the full notional amount of the derivative, may result in classification of a large portion of a portfolio that makes significant use of derivatives as falling within the lesser liquidity buckets.

<u>Three-Day Liquid Asset Minimum</u>. As part of the fund's liquidity risk management program, the proposed new rule would require each fund to set a "three-day liquid asset minimum," defined as the percentage of the fund's net assets to be invested in three-day liquid assets.[19] In determining its three-day liquid asset minimum, a fund would be required to consider the Liquidity Risk Factors noted above. A fund's board, including a majority of the funds' independent directors, would be required to approve the fund's three-day liquid asset minimum (including any changes to the fund's three-day liquid asset minimum), and a fund would be required to maintain a written record of how the minimum was determined. The SEC noted, in proposing a liquid asset minimum based on three days, that most funds sell at least some of their shares through broker-dealers, and thus, as a practical matter, are required as a result of Rule 15c6-1 under the Securities Exchange Act of 1934 to meet redemptions within three business days.[20] Consideration of the Liquidity Risk Factors, board oversight, and public disclosure of the fund's three-day liquid asset minimum should, in the SEC's view, constrain funds from setting an inappropriately low minimum in light of a fund's liquidity needs and risks.[21] Given the potential for second-guessing when the amount proves inadequate in a particular situation, it is possible that funds may be inclined to set an excessively high threshold, potentially impacting fund performance.

Under the proposed new rule, a fund would not be permitted to acquire 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.[22] The proposed new rule would not, however, require the fund, should its three-day liquid assets temporarily drop below the fund's three-day liquid asset minimum, to divest less liquid assets and reinvest the proceeds in three-day liquid assets.[23]

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[18] Securities Trading Practices of Registered Investment Companies, Investment Company Act Release No. 10666 (Apr. 18, 1979).

[19] *See* Proposed Rule 22e-4(a)(8), which defines a three-day liquid asset as any cash held by a fund and any position of a fund in an asset (or portion of the fund's position in an asset) that the fund believes is convertible into cash within three business days at a price that does not materially affect the value of that asset immediately prior to sale.

[20] Proposing Release, at 132. Commissioner Piwowar stated in his remarks at the open meeting that he would prefer a seven-day liquid asset minimum, as opposed to the proposed three days, as Section 22(e) of the Investment Company Act requires redemptions within seven days.

[21] Proposing Release, at 141.

[22] Proposed Rule 22e-4(b)(2)(iv)(C).

[23] Proposing Release, at 142-43.

Each fund would be required to periodically review, no less frequently than semi-annually, the adequacy of the fund's three-day liquid asset minimum and, in conducting such a review, take into account the Liquidity Risk Factors.[24]

15% Standard. Proposed new Rule 22e-4, as noted above, would codify the 15% guidance and define a "15% standard asset" as an asset that may not be sold or disposed of in the ordinary course of business within seven calendar days at approximately the value ascribed to it by the fund.[25] The SEC takes the view that this restriction is an important limitation on the acquisition of illiquid holdings, such as private equity investments, securities acquired in an initial public offering, and real estate assets.[26] The proposed new rule would prohibit a fund from acquiring any new illiquid asset if, immediately after the acquisition, the fund would have invested more than 15% of its net assets in 15% standard assets. The provision, however, would not require a fund to divest any holdings if 15% standard assets rise above 15% of its net assets due to factors other than purchases of a 15% standard asset.

In order to treat an asset as liquid for purposes of assigning an asset (or portion of an asset) to a liquidity bucket, the codified rule would require a fund to determine that it would be able to receive the proceeds from the asset sale within seven days (as opposed to just be able to enter into a contract of sale with respect to the asset within seven days). In addition, in evaluating how an instrument will be classified for purposes of the liquidity buckets, funds would now be required to take into account market factors and position size. In contrast, the SEC noted that for purposes of the 15% illiquidity limit, the fund does not have to consider the size of the fund's position in the asset or the number of days associated with receipt of proceeds of sale or disposition of the asset. The only relevant consideration is whether the asset can be sold within seven days at approximately its current value.

Redemptions in Kind. Along with ETFs, which commonly redeem shares in kind, many mutual funds reserve the right to redeem their shares in kind instead of cash. Under the new rule, a fund that may engage in in-kind redemptions would be required to adopt and implement written policies and procedures regarding in-kind redemptions.[27] The SEC expects these policies and procedures would address the process for redeeming in kind, as well as the circumstances under which the fund would consider redeeming in kind.[28] This requirement is in many ways duplicative of the requirements applicable to funds under Rule 38a-1 under the Investment Company Act.

[24] Proposed Rule 22e-4(b)(2)(iv)(B).

[25] Proposed Rule 22e-4(a)(4).

[26] Proposing Release, at 153.

[27] Proposed Rule 22e-4(b)(2)(iv)(E).

[28] Proposing Release, at 160-61.

Board Approval. The proposed new rule would require the fund's board of directors, including a majority of independent directors, to approve each fund's written liquidity management program as well as the appointment of a party to administer the program.[29] The SEC explained that directors may satisfy their obligations with respect to approval of the program by reviewing summaries of the liquidity risk management program prepared by the party tasked with administering the program, legal counsel, or other persons familiar with the liquidity risk management program.[30] The summaries should familiarize directors with the salient features of the program and provide them with an understanding of how the liquidity risk management program addresses the required assessment of the fund's liquidity risk, including how the fund's investment adviser or officers administering the program determined the fund's three-day liquid asset minimum. In considering whether to approve a fund's liquidity risk management program, the SEC noted that the board may wish to consider the nature of the fund's liquidity risk exposure and recent experiences regarding the fund's liquidity, including any redemption pressures experienced by the fund.

The proposed new rule would also require each fund to obtain approval of any material changes to the fund's liquidity risk management program, including changes to the fund's three-day liquid asset minimum, from the fund's board of directors.[31] In addition, a fund's board would be responsible for reviewing annually a written report from those tasked with administering the program. The report would be required to review the adequacy of the fund's liquidity risk management program.[32]

Recordkeeping. The proposed new Rule 22e-4 would 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;[33]
- maintain copies of any material provided to its board in connection with the board's initial approval of the fund's liquidity risk management program;[34] and
- keep a written record of how its three-day liquid asset minimum, and any adjustments thereto, were determined. Funds would have to maintain such records for a period of not less than five years (or at least five years after the end of the fiscal year in which the documents were provided to the board, as applicable), the first two years in an easily accessible place.

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[29] Proposed Rule 22e-4(b)(3)(iii).

[30] Proposing Release, at 175.

[31] Proposed Rule 22e-4(b)(3)(i).

[32] Proposed Rule 22e-4(b)(3)(ii).

[33] Proposed Rule 22e-4(c)(1).

[34] Proposed Rule 22e-4(c)(2); *see also* Proposed Rule 22e-4(b)(3)(i)-(ii).

Compliance Date. The SEC has proposed a tiered compliance date based on asset size for proposed new Rule 22e-4. For larger entities, meaning funds that together with other investment companies in the same "group of related investment companies"[35] have net assets of $1 billion or more at the end of the most recent fiscal year, the SEC is proposing a compliance date of 18 months after the effective date to comply with the proposed new rule. For smaller entities (*i.e.*, funds that together with other investment companies in the same "group of related investment companies" that have net assets of less than $1 billion as of the end of the most recent fiscal year), the SEC is proposing an additional 12 months (or 30 months after the effective date) to comply with proposed new Rule 22e-4.

II. Swing Pricing

Rule 22c-1 under the Investment Company Act currently requires a fund, its principal underwriter, dealers in the fund's shares, and other persons designated in the fund's prospectus, 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 the shares. When a fund trades portfolio assets as a result of purchase or redemption requests, costs associated with this trading activity can dilute the value of existing shareholders' interests in the fund.[36]

The SEC noted that certain foreign funds permit "swing pricing," which provides for adjustment of a fund's NAV to effectively pass on the costs stemming from shareholder purchase and redemption activity to the shareholders associated with that activity. The adjustments are designed to protect existing shareholders from dilution. Proposed amendments to Rule 22c-1 would permit open-end funds (other than ETFs and money market funds) to establish and implement swing pricing policies and procedures that would require a fund to adjust its NAV to account for large purchases and redemptions, provided the fund's board approves these policies and procedures and any amendments.[37] A fund's policies and procedures would provide that the fund would adjust its NAV by an amount designated as the "swing factor" once the level of net purchases into or net redemptions from the fund had exceeded a specified percentage of the fund's NAV known as the "swing threshold."[38] While the goal of swing pricing is to remove the "first mover" advantage by spreading costs across all purchasers or redeemers after the threshold is reached, it is possible that this would encourage investors to redeem quickly in order to avoid the impact of swing pricing or gravitate to funds that have not elected to impose swing

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[35] For these purposes, the SEC expects that the threshold would be based on the definition of "group of related investment companies," as such term is defined in rule 0-10 under the Investment Company Act. Rule 0-10 defines the term in part as "two or more management companies (including series thereof) that: (i) hold themselves out to investors as related companies for purposes of investment and investor services; and (ii) either: (A) have a common investment adviser or have investment advisers that are affiliated persons of each other; or (B) have a common administrator . . . ." Proposing Release, at 268 n.586.

[36] Proposing Release, at 184.

[37] Proposed Rule 22c-1(a)(3)(ii)(A).

[38] Proposed Rule 22c-1(a)(3)(i)(A).

pricing. This first mover advantage might be aggravated by the tendency of modern distribution to be concentrated in a limited number of intermediaries.

The proposed swing pricing provisions would require that the swing threshold be the same for both purchases and redemptions. As a result, a fund electing to adopt swing pricing would have to use swing pricing for both purchases and redemptions. The SEC requested comment on whether the proposed rule should instead only require a fund that adopts swing pricing policies and procedures to adjust the fund's NAV when the fund's level of net redemptions exceeds the swing threshold.[39] Funds would be required under the proposed amended rule to exclude any purchases or redemptions that are made in kind.[40] Swing pricing would apply to master-feeder funds only when redemptions or purchases impact the master fund.[41]

Determining the Fund's Swing Threshold. In specifying its swing threshold, the proposed amended rule would require a fund to consider:

- 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.[42]

The proposed rule would require at least annual review of the fund's swing pricing policies and procedures.[43]

Calculating the Fund's Swing Factor. The proposed amended rule does not mandate a particular swing factor or swing threshold. Instead, the proposed amended rule would require that the determination of the swing factor, as well as any upper limit on the swing factor, take 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, including any market impact costs, spread costs, and transaction fees and charges arising from asset purchases or sales to satisfy

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[39] Proposing Release, at 201.

[40] Proposed Rule 22c-1(a)(3)(i)(A).

[41] *See* Proposed Rule 22c-1(a)(3)(iv).

[42] Proposed Rule 22c-1(a)(3)(i)(B).

[43] Proposed Rule 22c-1(a)(3)(i)(C).

those purchases or redemptions, as well as any borrowing-related costs associated with satisfying redemptions.[44] Interestingly, the potential tax consequences resulting from the net purchases or redemptions are not required to be taken into account. The policies and procedures related to the determination of the swing factor would also require information about the value of assets purchased or sold by the fund as a result of net purchases or net redemptions.[45] This factor is meant to reflect the fact that a fund's NAV will generally not reflect changes in the holdings of the fund's portfolio assets and changes in the number of the fund's outstanding shares until the first business day after the fund's receipt of purchase and redemption requests.

As with the liquidity management program, the board would be required to designate the fund's adviser or officers responsible for the administration of the fund's swing pricing policies and procedures, including the responsibility for determining a swing factor when the fund's swing threshold is breached.[46] The SEC noted that the determination of the swing factor should be reasonably segregated from the portfolio management function of the fund.[47]

Recordkeeping. Proposed Rule 22c-1(a)(3) would require a fund to maintain a written copy of swing policies and procedures adopted by the fund that are in effect, or at any time within the past six years were in effect, in an easily accessible place.[48] In addition, proposed amendments to current Rule 31a-2(a)(2) under the Investment Company Act, which requires a fund to keep records evidencing and supporting each computation of the fund's NAV, would reflect the NAV adjustments based on a fund's swing pricing policies and procedures.[49]

Compliance Date. The SEC expects that a fund would be able to use swing pricing immediately after the effective date.[50]

III. Disclosure and Reporting Requirements

The SEC also approved proposed amendments to Form N-1A, the registration form used by open-end investment companies, and two recently proposed reporting forms, N-PORT and N-CEN. These amendments will provide information to allow investors, intermediaries, and regulators, to compare funds in terms of liquidity.

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[44] Proposed Rule 22c-1(a)(3)(i)(D)*(1).*

[45] Proposed Rule 22c-1(a)(3)(i)(D)*(2).*

[46] Proposed Rule 22c-1(a)(3)(ii)(B).

[47] Proposing Release, at 234 ("For example, if a committee were tasked with determining the swing factor(s) the fund would use in a variety of circumstances, we believe it would be appropriate for the fund's portfolio manager to provide inputs to be used by that committee in determining the swing factor, but not to decide how those inputs would be employed in the swing factor determination.").

[48] Proposed Rule 22c-1(a)(3)(iii).

[49] *See* Proposed Amendment to Rule 31a-2(a)(2).

[50] Proposing Release, at 269-70.

Form N-1A. Proposed amendments to Form N-1A would require funds to disclose in the fund's prospectus the number of days in which the fund pays redemption proceeds to redeeming shareholders (and the number of days for each distribution channel, if different) and the methods that the fund uses to meet redemption requests.[51] The proposed amendments would also require a fund to file as an exhibit to its registration statement any agreements related to lines of credit for the benefit of the fund.[52] Should a fund use swing pricing, it would have to explain in the prospectus the circumstances under which swing pricing would be required to be used as well as the effects of swing pricing.[53] The proposal is not specific on whether the swing pricing threshold is required to be disclosed as one of those "circumstances." A fund that uses swing financing would also be required to disclose the per share impact of amounts related to swing pricing below the total distributions line in the fund's financial highlights.[54] The SEC has proposed a six-month implementation date for registration statement disclosure.[55]

Proposed Form N-PORT. Proposed amendments to the portfolio holdings reporting form that the SEC proposed in May 2015, Form N-PORT, would require funds to report the liquidity classification of each of the fund's assets based on the six liquidity classifications in proposed new Rule 22e-4. For portfolio assets with multiple liquidity classifications, the proposed amendments would require funds to indicate the dollar amount attributable to each classification.[56] A fund would also be required to disclose its three-day liquid asset minimum, in addition to the requirement proposed in May 2015 that funds report whether an asset is a 15% standard asset. Similar to the tiered compliance dates (as described above) for proposed new Rule 22e-4, the SEC proposed a compliance date with proposed Form N-PORT of 18 months after the effective date for larger entities and 30 months after the effective date for smaller entities.[57]

Proposed Form N-CEN. Proposed amendments to the census reporting form that the SEC also proposed in May 2015, Form N-CEN, would require funds to disclose information regarding committed lines of credit, inter-fund borrowing and lending, and whether a fund engaged in swing pricing during the reporting period. The proposed amendments would also require ETFs to report whether they required an authorized participant to post collateral to the ETF or any of its designated service providers in connection with the purchase or redemption of ETF shares. The SEC proposed a compliance date of 18 months after the effective date to comply with proposed Form N-CEN.[58]

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[51] *See* Proposed Item 11(c)(7) of Form N-1A.

[52] *See* Proposed Item 28(h) of Form N-1A.

[53] *See* Proposed Item 6(d) of Form N-1A.

[54] *See* Proposed Item 13 of Form N-1A.

[55] Proposing Release, at 270.

[56] See Proposed Item C.13 of Form N-Port.

[57] Proposing Release, at 270-71.

[58] Proposing Release, at 271.

IV. Conclusion

These new proposals are the second in a suite of initiatives by the SEC to collect data and enhance risk management within a regulatory area where the Financial Stability Oversight Council and other international coordinating bodies have threatened to encroach on the SEC's jurisdiction and treat asset managers and the products and services they offer as systematically important.[59] Although the individual proposals to date have presented incremental changes and, if adopted with some appropriate changes and clarifications, may prove manageable for most fund complexes, the cumulative effect of the Chair's proposed initiatives may yet prove overly ambitious and burdensome. Moreover, although these new liquidity management proposals are designed to protect shareholders against liquidity freezes, the proposal could potentially contribute to market volatility and liquidity freezes by indirectly causing funds to sell assets to maintain or improve their liquidity profiles due to changes in market conditions or other factors. In periods of net redemptions in a particular asset class affecting multiple funds across multiple fund families, funds with more assets in longer liquidity classifications may be hit harder with redemptions, exacerbating the problem and potentially creating incentives for funds to be the "first mover" in periods of market volatility.

If you have any questions regarding this memorandum, please contact P. Georgia Bullitt (212-728-8250; gbullitt@willkie.com), James R. Burns (202-303-1241; jburns@willkie.com), Rose F. DiMartino (212-728-8215; rdimartino@willkie.com), Benjamin J. Haskin (202-303-1124; bhaskin@willkie.com), James W. Hahn (202-303-1228; jhahn@willkie.com) or the Willkie attorney with whom you regularly work.

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[59] *See* Willkie Farr & Gallagher LLP, Client Memorandum: "A Detailed Look Into the SEC's Investment Company Reporting Proposals" (June 22, 2015), *available* here; Investment Company Reporting Modernization, Investment Company Act Release No. 31610 (May 20, 2015), *available* here; Willkie Farr & Gallagher LLP, Client Memorandum: "SEC Proposes Public Disclosure Regarding Separately Managed Accounts, Changes to Adviser Registration and Enhanced Recordkeeping Around Adviser Performance" (June 5, 2015), *available* here; Amendments to Form ADV and Investment Advisers Act Rules, Investment Advisers Act of 1940 Release No. 4091 (May 20, 2015), *available* here.