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Investment Management, Trading & Markets ADVISORY ■

OCTOBER 14, 2016

SEC Approves Liquidity Risk Management Rules for Mutual Funds and ETFs

by David Baum and Brian Lawrence

On October 13, 2016, at an open meeting, the U.S. Securities and Exchange Commission (SEC) voted to approve three rules designed to enhance effective liquidity risk management by open-end funds, including mutual funds and exchange-traded funds (ETFs). The three rules created new forms and rules under the Investment Company Act of 1940 ("1940 Act"), as amended, and amended certain existing forms and rules under the 1940 Act. While the SEC adopted these three rules, it declined to adopt a provision that would have allowed funds to send shareholders their statements electronically by default, which Chair Mary Jo White indicated the SEC staff will continue to study.

The three rules the SEC approved related to disclosure and reporting requirements, liquidity risk management programs and swing pricing.

Disclosure and Reporting Requirements

Form N-Port

The new rules create new Form N-Port, which replaces current Form N-Q and requires funds, other than money market funds, to report monthly to the SEC as of the last day of the month portfolio-wide and position-level holdings data, including data related to the pricing of portfolio securities, information regarding repurchase agreements, securities lending activities and counterparty exposures, terms of derivatives contracts and certain portfolio-level and position-level risk measures. The new rules also require that Form N-Port be made publicly available on a quarterly basis, 60 days after the end of each quarter.

Form N-CEN

New Form N-CEN replaces current Form N-SAR and will require funds to disclose certain census-type information, including information regarding use of lines of credit, interfund borrowing and lending, and swing pricing. Form N-CEN also will require ETFs to disclose whether they are in-kind ETFs under the rule. Form N-CEN will be due 75 days following the end of a fund's fiscal year.

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Form N-1A

The new rules also amend Form N-1A, the registration form for open-end funds, to require funds to describe their procedures for redeeming fund shares, the number of days in which the fund typically expects to pay redemption proceeds and the methods for meeting redemption requests. The amendments to Form N-1A, as well as amendments to Regulation S-X, also address financial statement and performance reporting related to swing pricing and require funds that use swing pricing to provide an explanation of such use in their registration statements.

Liquidity Risk Management Programs

The SEC also approved Rule 22e-4, which will require funds, except for money market funds, to have a liquidity risk management program. The liquidity risk management program would have to include the following elements:

- Assessment, management and periodic review of a fund's liquidity risk ("liquidity risk" would be defined as the risk that a fund could not meet requests to redeem shares issued by the fund without significant dilution of the remaining investors' interests in the fund).
- Classification of the liquidity of fund portfolio investments (funds would be required to classify each investment into one of four liquidity categories: highly liquid investments, moderately liquid investments, less liquid investments and illiquid investments).
- Determination of a highly liquid investment minimum ("highly liquid investments" would be defined as cash or investments that are reasonably expected to be converted to cash within three business days without significantly changing the market value of the investment).

The new rules also codify a 15 percent limitation on illiquid investments (i.e., an investment that the fund reasonably expects cannot be sold in current market conditions within seven calendar days without significantly changing the market value of the investment) and require a fund's board, including a majority of the fund's independent directors, to approve, and review at least annually, the fund's liquidity risk management program and the designation of the fund's adviser or officer who will administer the program.

Finally, the new rules require a fund to confidentially notify the SEC when the fund's level of illiquid assets exceeds 15 percent of its net assets or when its highly liquid investments fall below its minimum for more than a brief period of time via new Form N-Liquid.

Swing Pricing

The SEC also voted to approve amendments to Rule 22c-1 of the 1940 Act that will permit, but not require, open-end funds (except money market funds or ETFs) to use swing pricing.

Swing pricing is the process of reflecting in a fund's net asset value (NAV) the costs associated with shareholders' trading activity in order to pass those costs on to the purchasing and redeeming shareholders.

A fund that chooses to use swing pricing would adjust its NAV by a specified amount (the "swing factor") once the level of net purchases into or net redemptions from the fund have exceeded a specified percentage or percentages of the fund's NAV known as the swing threshold. 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 2 percent of NAV per share.

The amendments also would require the fund's board to approve the fund's swing pricing policies and procedures and periodically review a written report on, among other things, adequacy of the fund's swing pricing policies and procedures. The board also would be required to approve the fund's swing factor upper limit, swing pricing threshold and any changes.

Effective Date

Most funds will be required to begin filing reports on new Forms N-PORT and N-CEN after June 1, 2018, while fund complexes with less than $1 billion in net assets will be required to begin filing reports on Form N-PORT after June 1, 2019. Amendments to Rule 22c-1 permitting swing pricing will go effective 24 months after the amendments are published in the *Federal Register*.

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