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Securities Alert

Liquidity Management and Reporting Modernization Rulemaking

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On October 13, 2016, the Securities and Exchange Commission (SEC) approved three new rules under the Investment Company Act of 1940 (Investment Company Act).[1] The new rules will impose liquidity requirements, authorize the use of swing pricing for certain funds and set forth new reporting obligations. In general, the final rules are more flexible and somewhat less prescriptive than the proposal, and exempt exchange-traded funds (ETFs) that effect redemptions in-kind from certain key requirements.

I. Liquidity Risk Management Programs (Rule 22e-4)

The SEC adopted Rule 22e-4 under the Investment Company Act (Rule 22e-4), which will require funds, including ETFs, to establish a written liquidity risk management program that is reasonably designed to assess and manage liquidity risk.[2] The new rule includes a definition of "liquidity risk" focused on whether a fund can meet redemption requests without significant dilution of remaining investors' interests, rather than, as proposed, whether a fund can meet redemption requests without materially affecting the fund's net asset value.[3] In general, Rule 22e-4 requires funds to adopt liquidity risk management programs that: (i) assess, manage and periodically review liquidity risk;[4] (ii) classify each portfolio investment into one of four categories and report such classifications to the Commission on Form N-PORT;[5] and (iii) designate a minimum amount that the fund must invest in highly liquid investments convertible to cash within three business days without significantly changing the investment's market value.[6] As described in more detail below, ETFs that redeem in-kind will be exempt from the Rule 22e-4 classification and highly liquid investment minimum requirements, and will not have to report portfolio classifications to the SEC.

All liquidity risk management programs, including ETFs that primarily redeem in-kind, must consider, if applicable, (i) the fund's investment strategy and the liquidity of its portfolio investments, both during normal and reasonably foreseeable stressed conditions, including whether the investment strategy is appropriate for an open-end fund; (ii) short-term and long-term cash flow projections during both normal and reasonably foreseeable stressed conditions; and (iii) holdings of cash and cash equivalents, as well as borrowing arrangements and other funding sources.[7] Fund boards will be required to approve the liquidity risk management program and designate the fund's investment adviser or officer(s) responsible

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[1] *See Investment Company Liquidity Risk Management Programs*, Investment Company Act Release No. 32315 (Liquidity Risk Management Release); *Investment Company Swing Pricing*, Investment Company Act Release No. 32316 (Swing Pricing Release); *Investment Company Reporting Modernization*, Investment Company Act Release No. 32314 (Reporting Modernization Release).
[2] *See* Rule 22e-4(b).
[3] *Compare* Rule 22e-4(a)(11), *with* Proposed Rule 22e-4(a)(7).
[4] *See* Rule 22e-4(b)(1)(i).
[5] *See* Rule 22e-4(b)(1)(ii).
[6] *See* Rule 22e-4(b)(1)(iii).
[7] *See* Rule 22e-4(b)(i).

for administering the fund's liquidity risk management program.[8] The administrator of the liquidity risk management program will be required at least annually to provide the board with a written report on the adequacy of the fund's liquidity risk management program, including the highly liquid investment minimum and the effectiveness of the program's implementation.[9]

Under the final rule, ETFs will be required to assess, manage and periodically review the fund's liquidity risk and needs, taking into account, as applicable, the liquidity risk factors for all funds. ETFs will also need to take into consideration additional factors in assessing liquidity risk, including the relationship between the liquidity of their portfolios and the arbitrage function.[10] Specifically, the Commission expressed concern that an ETF that maintains a significant amount of illiquid securities in its portfolio could disrupt the arbitrage function and cause premiums and discounts to increase.[11] Additionally, ETFs must consider the effect of the composition of baskets on the overall liquidity of the portfolio. The Liquidity Risk Management Release noted that a basket that "does not reflect a *pro rata* share of the fund's portfolio may alter the liquidity profile of the ETF's portfolio and may adversely affect the fund's future ability to meet cash redemptions or mitigate shareholder dilution."[12]

Rule 22e-4 will require funds to classify each portfolio investment's level of liquidity into one of four categories, based on the number of days in which the fund's investment would be convertible to cash in current market conditions without the sale *significantly changing* its market value. This standard differs from the initial proposal that would have required funds to assess the risk of meeting those redemptions "without *materially affecting* the value of the asset immediately prior to sale." The Commission noted that the new standard is less likely to capture "very small movements in price," responding to industry concerns that any sale of an investment could affect its market value to some degree. Funds will be required to review their portfolio investment's classifications at least monthly and report the liquidity classification for each portfolio investment on Form N-PORT.[13]

Under Rule 22e-4, a fund will be able to determine its own highly liquid investment minimum, as well as the assets it will hold to satisfy its minimum.[14] Unlike the proposed rule, Rule 22e-4 will not prohibit a fund from purchasing securities other than highly liquid investments if the fund falls below its minimum. Rule 22e-4 will require a fund that falls below its highly liquid investment minimum to report the occurrence to the fund's board at the next scheduled meeting. However, if the fund falls below its minimum for more than seven calendar days, the fund will be required to: (i) report the occurrence to the board within one business day; (ii) notify the Commission on new Form N-LIQUID (a confidential filing) within one business day; and (iii) develop and provide to the board a plan for restoring the minimum within a reasonable period of time.[15] If the amount of the fund's illiquid investments goes above the 15 percent illiquid investment limit, after 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 it continues to be in the best interest of the fund.[16] Under Rule 22e-4, boards will not be required to approve the highly liquid investment minimum, nor approve changes to it, except in the limited

[8] *See* Rule 22e-4(b)(2)(ii). The Commission noted that a fund's sub-adviser could be designated as the administrator of the program if appropriate. *See* Liquidity Risk Management Release at 251 n. 810.
[9] *See* Rule 22e-4(b)(2)(iii).
[10] *See* Liquidity Risk Management Release at 272. The Liquidity Risk Management Release noted that commenters recommended that that the two percent limit on ETF transaction fees be eliminated because doing so would improve the liquidity of ETF shares on the secondary market (by reducing spreads) and would protect ETFs from the dilution associated with transaction costs in excess of two percent. *See, e.g.,* Letter from Dechert LLP to Brent J. Fields, Secretary, Securities and Exchange Commission (January 13, 2016); Letter from David W. Blass, General Counsel, Investment Company Institute, to Brent J. Fields, Secretary, Securities and Exchange Commission (January 13, 2016). The Commission determined that addressing the ETF transaction cost issue was "beyond the scope of this rulemaking."
[11] *Id.* at 270-71.
[12] *Id.* at 272.
[13] *See* Rule 22e-4(b)(1)(ii).
[14] *See* Rule 22e-4(b)(1)(iii)(A)(1).
[15] *See* Rule 22e-4(b)(1)(iii); *See also* Part D of Form N-LIQUID.
[16] *See* Rule 22e-(4)(b)(1)(iv)(B).

circumstances where a fund seeks to change the minimum while the fund is below the preestablished minimum.

In one of the most significant changes to the proposal, In-Kind ETFs (as defined below) will be excluded from the classification and highly liquid investment minimum requirements, and will not be required to report portfolio liquidity classifications. Rule 22e-4 defines an "In-Kind ETF" as an ETF that meets redemptions through in-kind transfers of securities, positions and assets other than a *de minimis* amount of cash (such as balancing amounts) and that publishes its portfolio holdings daily.[17] The Liquidity Risk Management Release states that an In-Kind ETF generally should describe in its policies and procedures for its liquidity risk management program, to the extent applicable, how the fund analyzes the ability of the ETF to redeem in-kind in all market conditions, the circumstances in which the In-Kind ETF may use a *de minimis* amount of cash to meet a redemption and what amount of cash would qualify as a *de minimis* amount. In making these determinations, an In-Kind ETF should consider, if applicable: (i) the amount and frequency with which cash is used to meet redemptions; and (ii) the circumstances and rationale for using cash to meet redemptions.[18]

Rule 22e-4 codifies previous SEC guidance limiting a fund's portfolio to 15 percent illiquid assets. In a change from the proposal, the final rule requires that the fund board be informed within one business day if the fund's holdings of illiquid investments exceed 15 percent of its net assets and report to the Commission by filing Form N-LIQUID.[19]

II. Reporting Requirements

The Commission voted to rescind Form N-Q and replace it with new Form N-PORT. Form N-PORT will be filed with the SEC on a monthly basis, and every third month the report will be made available to the public 60 days after the end of the quarter.[20] Form N-PORT will apply to all registered funds (including ETFs), except money market funds and small-business investment companies. For the first time, funds will be required to report information about their complete portfolio holdings monthly and in a structured XML format.[21] Lastly, funds will be required to report extensive new information about their use of derivatives, certain risk metrics, securities lending activities, liquidity and pricing of portfolio instruments.[22]

The Commission also voted to rescind Form N-SAR and replace it with new Form N-CEN. Funds will be required to file Form N-CEN on an annual basis within 60 days of the end of the fiscal year, instead of semiannually as required for Form N-SAR. Form N-CEN will be filed in XML format, replacing the current MS-DOS format of N-SAR. Form N-CEN will incorporate many of the same data elements currently reported on Form N-SAR.

The new Form N-CEN requires ETFs and exchange-traded managed funds (ETMFs) to provide the Commission with a significant amount of new information.[23] In addition to identifying each authorized participant (AP) and certain other identifying information, ETFs must report the dollar value of shares that

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[17] *See* Rule 22e-4(a)(9). The release acknowledges that ETFs that typically redeem in-kind may use cash for several reasons, such as making up any difference between the net asset value attributable to a creation unit and the aggregate market value of the creation basket exchanged, corresponding with uninvested cash in the fund's portfolio, and substituting for a portfolio position or asset that is not eligible to be transferred in-kind. *See* Liquidity Risk Management Release at 266.
[18] *See id.* at 267.
[19] *See* Rule 22e-4(b)(1)(iv); *see also* Part B of Form N-LIQUID.
[20] *See* General Instruction F of Form N-PORT.
[21] Notably, the Commission clarified that funds will be permitted to report monthly information on a T+1 basis, as is currently permitted under Rule 2a-4 for the calculation of funds' net asset values. The modification comes as an instruction to Form N-PORT, directing funds to report portfolio information on Form N-PORT on the same basis as they use to calculate their net asset value. In response to commenters, the Commission also modified the final rule to permit the use of different internal methodologies in responding to certain items on Form N-PORT. *See* General Instructions A and G of Form N-PORT.
[22] *See* Investment Company Reporting Modernization, Release No. IC-32314 at 23.
[23] *See* Item E of Form N-CEN.

each AP purchased and redeemed from the ETF during the reporting period. The new Form N-CEN requires ETFs to report whether APs were required to post collateral to the ETF or any of its designated service providers in connection with the purchase or redemption of ETF shares during the reporting period.[24] ETFs will also be required to report, based on the dollar value paid for each creation unit purchased or redeemed by APs during the reporting period, certain metrics relating to the percentage of cash relative to in-kind redemptions.[25] Under the final rule, ETFs will be required to report the average transaction fee (i) charged in dollars per creation unit,[26] (ii) charged for one or more creation units on the same business day,[27] and (iii) charged as a percentage of the value of the creation unit.[28] ETFs will also be required to report, as to only those creation units purchased by APs that were fully or partially composed of cash, the average transaction fee (i) charged in dollars per creation unit,[29] (ii) charged for one or more creation units on the same business day,[30] and (iii) charged as a percentage of the value of the cash in the creation unit.[31] Finally, ETFs will be required to report the parallel information for the redemption of creation units by APs.[32]

III. Swing Pricing (Amended Rule 22c-1)

The Commission amended Rule 22c-1 to authorize funds, except money market funds and ETFs, to engage in "swing pricing."[33] Rule 22c-1 maintains the optionality of adopting swing pricing,[34] and incorporates a series of modifications from the rule as proposed. Such modifications include: (i) more defined roles for boards and fund managers;[35] (ii) more limited discretion in setting the swing factor by specifying the process for how the fund's swing threshold(s) will be determined;[36] and (iii) an upper limit on the fund's swing factor that does not exceed two percent.[37] This two percent limit on swing pricing for mutual funds will operate to limit the effectiveness of swing pricing to prevent dilution of remaining shareholders, just as it does for ETF transaction fees. Nonetheless, the Commission determined that the limit was necessary to avoid effectively creating a gate against redemptions.[38]

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[24] *See* Item E.2 of Form N-CEN.
[25] *See* Item E.3 of Form N-CEN.
[26] *See* Item E.3.d.i.1 Form N-CEN.
[27] *See* Item E.3.d.i.2 Form N-CEN.
[28] *See* Item E.3.d.i.3 Form N-CEN.
[29] *See* Item E.3.d.ii.1 Form N-CEN.
[30] *See* Item E.3.d.ii.2 Form N-CEN.
[31] *See* Item E.3.d.ii.3 Form N-CEN.
[32] *See* Item E.3.e.
[33] *See* Rule 22c-1(a)(3). In spite of several commenters highlighting potential dilutive effects caused by the current restrictions on ETF redemption transaction fees, the Commission chose to exempt ETFs rationalizing that "because they redeem directly only with authorized participants, [ETFs] are generally able to utilize transaction fees to pass on certain costs associated with redemptions." Swing Pricing Release at 19. The Commission also expressed concern that swing pricing could impede the effective functioning of an ETF's arbitrage mechanism by interfering with an AP's ability to assess whether an arbitrage opportunity exists due to uncertainty over net asset value adjustments. *See id.* at 23.
[34] *See* Rule 22c-1(a)(3).
[35] *See* Rule 22c-1(a)(3)(ii). Amended Rule 22c-1 requires the board to review, no less frequently than annually, a written report prepared by the administrator of the fund's swing pricing policies and procedures. This written report must describe: (i) the swing pricing administrator's review of the adequacy of the fund's swing pricing policies and procedures and the effectiveness of their implementation, including the impact on mitigating dilution; (ii) material changes to the policies and procedures since the date of the last report; and (iii) the swing pricing administrator's review and assessment of the fund's swing threshold(s), swing factor(s) and swing factor upper limit considering the requirements of the rule, including a review and assessment of information and data supporting these determinations.
[36] *See* Rule 22c-1(a)(3)(i)(B). Funds will be required to consider: (i) the size, frequency, and volatility of historical net purchases or net redemptions of fund shares during normal and stressed periods; (ii) the fund's investment strategy and the liquidity of the fund's portfolio investments; (iii) the fund's holding of cash and cash equivalents, and borrowing arrangements and other funding sources; and (iv) the costs associated with transactions in the markets in which the fund invests.
[37] *See* Rule 22c-1(a)(3)(i)(C).
[38] *See* Swing Pricing Release at 80-81.

IV. Effective Dates

The Commission announced that most funds will be required to file reports on new Forms N-PORT and N-CEN after June 1, 2018, but fund complexes with less than $1 billion in net assets will be required to file reports on Form N-PORT after June 1, 2019. The Commission stated that most funds will be required to comply with the liquidity risk management program requirements on December 1, 2018. Fund complexes with less than $1 billion in net assets will be required to comply on June 1, 2019. Lastly, the Commission is delaying the effective date of amendments that would permit funds to use swing pricing; they will become effective 24 months after publication in the Federal Register.

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