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SEC Proposes Rules to Require Funds to Adopt Liquidity Risk Management Programs; Allow "Swing Pricing"

By Jay G. Baris

At an open meeting today, the SEC proposed new rules and amendments to existing rules to require open-end investment companies to adopt comprehensive liquidity risk management programs. The rules would also allow funds to use "swing pricing" to pass on the cost of large purchases and redemptions to the shareholders that cause those costs.

The SEC also proposed rules that would require funds to categorize the liquidity of each portfolio holding, and to report to the SEC the category assigned to each portfolio security.

Chair Mary Jo White said that the Commission's purpose in adopting the proposals is to enhance management of liquidity risks of registered open-end investment companies, including mutual funds and exchange-traded funds.

Here is a brief summary of the proposals.

Liquidity risk management programs

In establishing liquidity risk management programs, funds (other than money market funds) would be required to assess their liquidity risk. The program would be tailored to the individual needs and risks of each fund. The rules would require a liquidity risk management program to include several elements, including:

- Classification of the liquidity of fund portfolio assets;
- Assessment, periodic review and management of a fund's liquidity risk;
- Establishment of a three-day liquid asset minimum; and
- Board approval and review.

Classification of liquidity risks. The rules would require funds to assign liquidity risks of individual portfolio securities to one of six liquidity categories. The classification would be based on the number of days in which a fund could convert the security to cash at a price that does not materially affect the value of the asset immediately prior to sale. In categorizing the liquidity of a particular security, funds would be required to consider all relevant liquidity factors, including trading frequency, volume, bid/ask spread and position size, among others. Funds could characterize a particular security in multiple categories, depending on its liquidity and the ability of the fund to sell that security without moving the market.

Assessment, periodic review and management of a fund's liquidity risk. Funds would be required to assess and periodically review their liquidity risk, based on specific factors. Liquidity risk means the risk that a fund could not meet expected liquidity risks under normal conditions or stressed conditions without materially affecting the fund's net asset value (NAV) per share.

Three-day liquid asset minimum. Based on this assessment, the rules would require a fund to determine a minimum amount of its portfolio to be held in cash or instruments that could be converted to cash within three days. This is the so-called "three-day liquid asset minimum." Fund boards would be required to approve the liquidity risk management programs and the three-day liquid asset minimum.

15 percent limit on investments in illiquid securities. The SEC would codify its long-standing policy to limit funds' investments in illiquid securities to 15 percent of net assets. Generally, a security is illiquid if it cannot be sold within seven days at approximately the price at which it has been valued.

Board approval and review. A fund's board, including a majority of the independent board members, would be required to approve the fund's liquidity risk management program, including the fund's three-day liquid asset minimum. The board would also be responsible for ongoing reviews of the program's adequacy.

Swing pricing option

Proposed amendments to Rule 22c-1 would allow, but not require, funds to use swing pricing under certain circumstances. That is, funds could adjust their NAV upward or downward when purchases or redemptions exceed a designated "swing threshold." The adjustment would be the "swing factor." Fund boards would approve the methodologies for calculating the swing threshold and swing factor. The goal is to ensure that large purchases and redemption requests are met in a timely manner while also minimizing shareholder dilution. The option would not be available to money market funds or ETFs.

Disclosure and reporting

Form N-1A. Proposed amendments to Form N-1A would require funds to disclose swing pricing, if applicable, and the methods used by funds to meet redemptions.

Form N-PORT. New Form N-PORT would require mutual funds and ETFs to report information about liquidity and the liquidity categories assigned to portfolio securities, including the fund's three-day liquid asset minimum.

Form N-CEN. Proposed amendments to the census reporting form would require funds to disclose information regarding committed lines of credit, interfund borrowing and lending, and swing pricing, among other things.

The Commissioners

Commissioner Kara Stein said that she was concerned that the proposed rules do not go far enough in certain areas. She implied that the Commission should consider tailoring regulation to specific funds that present the most concern from a redeemability perspective.

Commissioner Michael S. Piwowar generally supported the proposals, but expressed concern about the proposed three-day liquid asset minimum requirement. He said that he preferred that the rule track the statutory requirement that funds make payment on redemptions within seven days.

Outgoing Commissioner Daniel M. Gallagher generally supported the proposals, but expressed reservations about the three-day liquid asset minimum and the use of swing pricing. Swing pricing, he said, could cause disproportionate harm to retail investors.

What's next?

Investment company use of derivatives. Chair White said that she expects the Commission's staff to finalize recommendations related to the use of derivatives by funds by the end of 2015. The recommendations may address specific limits on leverage.

Request for comments. The SEC is asking for comments on whether more substantive regulation is needed for certain types of investment companies that may present greater liquidity risks. The comment period will be 90 days after publication in the *Federal Register.*

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This summary is based on information made available at the Commission's open meeting. We will update this report as more information becomes available.

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