

Client Alert

Current Issues Relevant to Our Clients

September 28, 2015

SEC Proposes Liquidity Management Rules for Mutual Funds and Exchange-Traded Funds

The Securities and Exchange Commission (the “SEC”) recently proposed new rules and amendments (the “Proposal”) designed to enhance liquidity risk management requirements for certain open-end management investment companies (“open-end funds”), including mutual funds and exchange-traded funds (“ETFs”) but excluding money market funds. Under the Proposal, covered funds would be required to implement liquidity risk management programs and enhance disclosure regarding fund liquidity and redemption practices. The Proposal also provides a framework under which certain open-end funds (excluding ETFs) could elect to use “swing pricing” to effectively pass on transactional costs stemming from shareholder purchase or redemption activity to the shareholders associated with that activity. The Proposal is available [here](#). The SEC’s notice of the Proposal is available [here](#).

Liquidity Risk Management Programs

Proposed Rule 22e-4 under the Investment Company Act of 1940, as amended (the “1940 Act”), would require any open-end fund (excluding money market funds) to implement a liquidity risk management program. A liquidity risk management program would be required to be reviewed and approved by a fund’s board and include (among other things):

- 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
- A fifteen percent limit on illiquid securities.

Classification of the Liquidity of Fund Portfolio Assets. A fund would be required to classify and engage in an ongoing review of each of the assets in its portfolio. The classification would be based on the number of days in which the fund’s position would be convertible to cash at a price that does not materially affect the value of that asset immediately prior to sale. Proposed Rule 22e-4 would include factors that a fund would be required to take into account when classifying the liquidity of each portfolio position, and portions of a single asset could be categorized into multiple categories based on factors included in the Proposal. Funds 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: one business day; 2-3 business days; 4-7 calendar days; 8-15 calendar days; 16-30 calendar days; or more than 30 calendar days.

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 specified factors. Liquidity risk would be defined as the risk that a fund could not meet redemption requests that are expected under normal conditions or under stressed conditions, without materially affecting the fund’s net asset value (“NAV”) per share.

Establishment of a Three-Day Liquid Asset Minimum. A fund would be required to determine, based on reasonable inquiry, a minimum percentage of its net assets that must be invested in (1) cash and (2) assets that are convertible to cash within three business days at a price that does not materially affect the value of the assets immediately prior to sale. The term “immediately prior to sale” is described in the Proposal as intended to reflect that the fund must determine whether the sales price the fund would receive for the asset would be reasonably expected to move the market price of the asset independent of other market forces affecting the asset’s value. It 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.

Fifteen Percent Limit on Illiquid Securities. Proposed Rule 22e-4 would codify the 15 percent limit on illiquid assets included in current SEC guidelines.

Board Approval and Review. A fund’s board, including a majority of the fund’s independent directors, would be

required to approve the fund's liquidity risk management program, including the fund's three-day liquid asset minimum. The board also would be responsible for reviewing a written report that analyzes the program's adequacy, which would be required to be provided at least annually by the fund's investment adviser or officer administering the program.

Swing Pricing for Mutual Funds

The Proposal would also permit, but not require, open-end funds (except money market funds or ETFs) to use "swing pricing." Swing pricing is the process of reflecting the costs associated with shareholders' trading activity in a fund's NAV in order to pass those costs on to the purchasing and redeeming shareholders. It is designed to protect existing shareholders from dilution associated with shareholder purchases and redemptions and, as proposed, would be another tool to help funds manage liquidity risks.

Under the Proposal, a fund that chooses to use swing pricing would reflect in its NAV a specified amount (the "swing factor") once the level of net purchases into or net redemptions from the fund exceeds a specified percentage of the fund's NAV (the "swing threshold"). The proposed amendments include factors that funds would be required to consider to determine the swing threshold and swing factor. The fund's board, including the independent directors, would be required to approve the fund's swing pricing policies and procedures.

Disclosure Regarding Fund Liquidity and Redemption Prices

The Proposal also includes amendments to the registration form used by open-end funds (Form N-1A) and two recently proposed reporting forms (Forms N-PORT and N-CEN).

Form N-1A. Proposed amendments would require funds to make disclosures regarding the use of swing pricing (if applicable), the methods used by funds to meet redemptions and to file agreements related to lines of credit.

Proposed Form N-PORT. Funds would be required to report the liquidity classification of each of the fund's assets based on the categories in proposed Rule 22e-4 and the three-day liquid asset minimum.

Proposed Form N-CEN. Funds would be required to disclose information regarding committed lines of credit, interfund borrowing and lending, and swing pricing. The proposed amendments also would 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.

What's Next

The comment period for the Proposal will last for 90 days after its publication in the Federal Register. Comments may be submitted [here](#), and submitted comments are available [here](#). Firms should consider the potential compliance and operational impact of the Proposal to their funds as well as their advisers and boards.

For More Information

To discuss any topic covered in this Client Alert, please contact a member of the Investment Management Group or visit us online at chapman.com.

This document has been prepared by Chapman and Cutler LLP attorneys for informational purposes only. It is general in nature and based on authorities that are subject to change. It is not intended as legal advice. Accordingly, readers should consult with, and seek the advice of, their own counsel with respect to any individual situation that involves the material contained in this document, the application of such material to their specific circumstances, or any questions relating to their own affairs that may be raised by such material.

To the extent that any part of this summary is interpreted to provide tax advice, (i) no taxpayer may rely upon this summary for the purposes of avoiding penalties, (ii) this summary may be interpreted for tax purposes as being prepared in connection with the promotion of the transactions described, and (iii) taxpayers should consult independent tax advisors.

© 2015 Chapman and Cutler LLP. All rights reserved.

Attorney Advertising Material.