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Prepare for SEC proposed rules:

Establish a liquidity risk management program

With a mid-January due date for comments on the SEC's proposed rules[1], open-end mutual funds and Exchange-Traded Funds (ETFs)[2] and their boards should get ready by reviewing their liquidity risk management policies and programs. The rules are designed to reduce risks associated with large redemption obligations in distressed or less liquid markets. They would require funds to adopt formal liquidity risk management programs. Comments on the proposed rules must be received by the SEC by January 13, 2016.

Four program components would be required

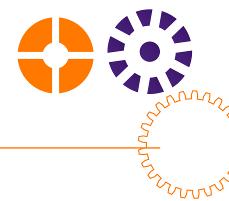
Proposed Rule 22e-4 under the Investment Company Act of 1940 would require funds to adopt and implement written liquidity risk management programs for each series of the registered open-end investment company. Programs would have to include four components:

- **liquidity classification:** for each position[3], the fund would specify the time needed to convert to cash, using these classifications:
  - within 1 business day;
  - within 2–3 business days;
  - within 4–7 calendar days;
  - within 8–15 calendar days;
  - within 16–30 calendar days; and
  - more than 30 calendar days.

The fund would also have to disclose the dollar amount of each classification in Form N-CSR and Form N-CSRS (annual and semi-annual shareholder reports), and Form N-PORT.

- **three-day liquid asset minimum:** under the proposed rule, each fund must determine a three-day liquid asset minimum - the proportion of a fund's net assets invested in three-day liquid assets. Three-day assets, or positions, are convertible into cash within three business days at a price that does not materially affect the asset's value. The fund's board must approve the three-day liquid asset minimum, and the fund must maintain a written record of how it was determined.
- **determining liquidity risk:** the proposed rule would require a fund to assess and review liquidity risk and make any necessary changes. The proposal codifies current SEC guidance that limits investments in illiquid assets to 15% of a fund's Net Asset Value (NAV). Under the rule, a fund would not be permitted to purchase an asset that could not be sold in the ordinary course of business within a seven-day period at a price that approximates fair value if the total asset sale would exceed 15% of a fund's NAV.
- **board reports:** those responsible for the fund's liquidity risk management program would be required to submit written reports to the fund's board. These reports should assess program effectiveness, define the current three-day liquid asset minimum and evaluate program implementation. Board approval should be considered necessary to change the fund's three-day liquid asset minimum.

[1] SEC. "Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release (Proposing Release)," SEC.gov, Sept. 22, 2015.
[2] Money market funds were not included in the proposed rules.
[3] For portfolio assets with multiple liquidity classifications, the proposed rule would require funds to indicate the dollar amount for each classification and make it available quarterly on Form N-PORT.



Swing pricing would be allowed

One element of the proposed rules is intended to protect shareholders from bearing the dilutive costs that could result during periods of heavy shareholder subscriptions and redemptions. During these periods, registered open-end funds - excluding ETFs and money market funds - would be allowed but not required to use swing pricing to reflect portfolio-trading costs in their NAVs. Mutual funds would be allowed to adjust their NAV when the volume of subscriptions or redemptions exceeds preapproved swing thresholds. If a fund elects to use swing pricing, the board should approve the methodology used for calculating the swing threshold and adjustment factor, based on the percentage of the fund's NAV. The board should also conduct an annual review of swing pricing policies and procedures.

Disclosure, reporting would undergo changes

The SEC proposals would also necessitate changes to Form N-1A, Form N-PORT and Form N-CEN[4]:

- **Form N-1A:** funds would discuss their liquidity risk management practices, including the methods used to meet shareholder redemptions and any use of swing pricing. They would also file any agreements related to lines of credit for the fund's benefit as exhibits to its registration statement;
- **Forms N-PORT, N-CSR and N-CSRS:** funds would report the liquidity classifications assigned to individual portfolio securities and the three-day liquid asset minimum; and
- **Form N-CEN:** funds would disclose information regarding committed lines of credit, swing pricing, interfund borrowing and lending.

Implementation time frames have been set

Despite no specific timeline for approval of the proposed rules, organisations should ready their liquidity risk management programs now. After the end of the comment period, and finalising and approval of the rules, larger fund complexes will have 18 months to formalise their program; smaller fund complexes will have 30 months.

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This content is not intended to answer specific questions or suggest suitability of action in a particular case. For additional information about the issues discussed, contact a Grant Thornton professional.

[4] Form N-PORT and Form N-CEN have not yet been formally approved by the SEC. As a result, the SEC is reopening the comment period for the proposed investment company reporting reforms announced earlier this year. See our July 20, 2015, article *SEC Seeks to Modernize Investment Reporting and Disclosures* for more information.

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