Going with the Flow and Managing Stress: Considering the SEC’s Liquidity Rule and Stress Testing Initiative

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Overview of Panel

» SEC’s Liquidity Risk Management Program Rule
» Swing Pricing Rule Amendments
» Related Disclosure Changes
» Stress Testing Initiatives: US and abroad
General Liquidity Rule Requirements

» Applies to open-end funds (excluding money market funds); limited review for UITs

» General program requirements:
  » Assessment, management, and periodic review of liquidity risk
  » Liquidity classification of portfolio investments
  » Highly liquid investment minimum
  » Illiquid investments limitation
  » Redemptions in kind policies and procedures
  » Board involvement
Assessment, Management, and Periodic Review of Liquidity Risk

» Liquidity risk: risk that a fund could not meet redemptions without significant dilution of remaining investors’ fund interests

» Specified factors:
  » Investment strategy and liquidity of portfolio investments
  » Short-term and long-term cash flow projections
  » Holdings of cash and cash equivalents, and borrowing/other funding sources
  » ETFs also consider: (i) portfolio liquidity and arbitrage function, and (ii) basket composition
Classify each investment into 1 of 4 buckets: days in which investment would be convertible to cash/sold (as applicable) in current market conditions without significantly changing market value

- “Highly liquid:” cash and investments convertible into cash within 3 business days
- “Moderately liquid:” investments convertible into cash in more than 3 calendar days but within 7 calendar days
- “Less liquid:” investments able to be sold within 7 calendar days but not settled in that period
- “Illiquid:” investments that cannot be sold within 7 calendar days
Liquidity Classifications of Portfolio Investments—Additional Considerations

» A fund:
  » May classify investments by asset class, subject to exceptions
  » Must consider position size (sizes that fund “would reasonably anticipate trading”) and market depth
  » Must identify % of highly liquid investments covering non-highly liquid derivatives transactions
» Additional classification guidance in release
» Exclusion for “in-kind ETFs”
Highly Liquid Investment Minimum

» Determine minimum % of net assets to invest in “highly liquid investments,” based on liquidity risk assessment
» Implement “shortfall” policies and procedures
» Report to board when minimum breached
» Report to SEC when minimum breached for more than 7 days
» Exclusion for “in-kind ETFs” and “primarily highly liquid funds”
Illiquid Investments Limitation

» 15% cap on illiquid investments
» Revised definition, incorporation into 4-bucket classification framework
» Reporting to board and SEC when cap is breached
Board Involvement

» Approve liquidity risk management program, designation of administrator
» Review annual report on adequacy and effectiveness of program
» Receive reports when fund breaches highly liquid minimum or 15% illiquid investments cap
New Liquidity Disclosure Requirements

» N-1A: Disclose information about paying and meeting redemptions

» N-PORT: Report aggregated % in each bucket; report to SEC (confidentially) position-level bucketing and highly liquid minimum information

» N-CEN: Disclose information about lines of credit, interfund borrowing/lending; whether ETF is “in-kind”

» N-LIQUID: Report (confidentially) to SEC breaches of highly liquid minimum (for more than 7 days) or 15% illiquid investments cap
Swing Pricing Amendments: Policies and Procedures

» Mutual funds *may* use swing pricing to mitigate dilution, per rule-compliant policies and procedures

» Policies and procedures must:
  » Provide that fund adjust its per share NAV by swing factor(s), once swing threshold(s) is crossed (“reasonable estimates” of flows permitted)
  » Determine swing threshold(s), considering certain factors
  » Determine swing factor(s) (which must be reasonable in relation to near-term costs, and include upper limit)
Swing Pricing Amendments: Board Responsibilities

» The fund board must:
  » Approve fund’s swing pricing policies and procedures
  » Approve fund’s swing threshold(s), swing factor upper limit, and changes to each
  » Designate swing pricing administrator
  » Review (at least annually) report from administrator about fund’s swing pricing policies and procedures
New Swing Pricing Disclosure Requirements

» N-1A: Report performance and financial information and explain fund’s use of swing pricing
» N-CEN: Report whether fund engaged in swing pricing, and swing factor upper limit
» Financial statements:
  » Disclose GAAP NAV on balance sheet
  » Reflect effects of swing pricing on capital share transactions and financial highlights
  » Include disclosure in notes to financial statements
» Performance reporting: Calculate total returns using GAAP NAV
Stress Testing Initiatives: US and Abroad

» Stress testing described in SEC’s liquidity rule adopting release as “particularly useful” in evaluating liquidity risk

» Dodd-Frank Act requires SEC to adopt annual stress testing requirements for large funds and advisers

» FSB’s 2016 Consultation recommended liquidity-oriented fund stress testing and more work by IOSCO

» IOSCO actively working on stress testing