

# **2016 Securities Law Developments Conference**

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# 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

# Liquidity Classifications of Portfolio Investments

- » 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