

# Implementing the New Liquidity Risk Management Program and Swing Pricing Requirements

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## I. Introduction and Background

The U.S. Securities and Exchange Commission (SEC or Commission) on October 13, 2016 unanimously adopted new rules and rule amendments to require registered open-end investment companies (including exchange-traded funds (ETFs) but excluding money market funds (MMFs)) to establish liquidity risk management programs.<sup>1</sup> The SEC also adopted rule amendments to permit – but not require – registered open-end investment companies (excluding MMFs and ETFs) to use “swing pricing.”<sup>2</sup> In addition, the Commission has imposed new disclosure and reporting requirements related to a fund’s liquidity risk management program and swing pricing.

The new rules and rule amendments represent significant changes to current liquidity management and reporting requirements and will require significant changes to fund operations, as well as disclosure and reporting requirements. This outline discusses the new liquidity risk management program implementation, disclosure and reporting requirements as well as the permissive use of swing pricing.

## II. Requirements of the Liquidity Risk Management Program

New Rule 22e-4 under the Investment Company Act of 1940 (1940 Act) (Liquidity Rule) requires funds,<sup>3</sup> including “In-Kind ETFs,”<sup>4</sup> to adopt and implement written liquidity risk management programs reasonably designed to assess and manage their liquidity risk. Each such program will be required to provide for the:

- assessment, management and periodic review of liquidity risk;
- classification and monthly review of the liquidity of portfolio investments; and
- determination and periodic review, and procedures to address a shortfall, of a highly liquid investment minimum.

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<sup>1</sup> See Investment Company Liquidity Risk Management Programs, Investment Company Act Rel. No. 32315 (Oct. 13, 2016) (Liquidity Program Adopting Release). On the same day, the Commission adopted, by a 2-to-1 vote, new rules and forms, as well as amendments to certain rules and forms, to modernize the reporting of information by registered investment companies. See Investment Company Reporting Modernization, Investment Company Act Rel. No. 32314 (Oct. 13, 2016).

<sup>2</sup> See Investment Company Swing Pricing, Investment Company Act. Rel. No. 32316 (Swing Pricing Adopting Release).

<sup>3</sup> For purposes of this outline, unless the context indicates otherwise, registered open-end investment companies, including ETFs and exchange-traded managed funds but excluding MMFs, are generally referred to herein as “funds.”

<sup>4</sup> An In-Kind ETF is an ETF that meets redemptions through in-kind transfers of securities, positions and assets other than a *de minimis* amount of cash, and which publishes its portfolio holdings daily.

## 1. *Liquidity Risk*

### a. *Definition*

The Liquidity Rule requires adoption of liquidity risk management programs that provide for the assessment, management and periodic (at least annual) review of funds' "liquidity risk." "Liquidity risk" is "the risk that the fund could not meet requests to redeem shares issued by the fund without significant dilution of remaining investors' interests in the fund."

### b. *Factors*

The assessment, management and review of liquidity risk must involve consideration of the following factors (Liquidity Risk Factors), as applicable:

- the fund's investment strategy and the liquidity of its portfolio assets during both normal and reasonably foreseeable stressed conditions, including whether the investment strategy is "appropriate for an open-end fund" the extent to which the fund's strategy involves a relatively concentrated portfolio or large positions in particular issuers, and the use of borrowings for investment purposes and derivatives;<sup>5</sup>
- short-term and long-term cash flow projections during both normal and reasonably foreseeable stressed conditions;
- holdings of cash and cash equivalents, as well as borrowing arrangements and other funding sources; and
- for ETFs: (i) the relationship between the ETF's portfolio liquidity and the way in which, and the prices and spreads at which, ETF shares trade, including the efficiency of the arbitrage function and the level of active participation by market participants (including authorized participants); and (ii) the effect of the composition of baskets on the overall liquidity of the ETF's portfolio.

## 2. *Liquidity Classification*

Under the Liquidity Rule, funds must classify portfolio investments' liquidity into one of four categories based on the number of days within which the fund determines that it reasonably expects an investment to be convertible to cash (or, for the "less-liquid" and "illiquid" categories, sold or disposed of), without significantly changing the market value of the investment. In-Kind ETFs are not subject to this requirement.

### a. *Liquidity Categories*

- **Highly liquid investments:** cash and any investment reasonably expected to be "convertible to cash"<sup>6</sup> in current market conditions in three business days or less without significantly changing the market value of the investment;
- **Moderately liquid investments:** any investments reasonably expected to be convertible to cash in current market conditions in more than three calendar days but no more than seven calendar days without significantly changing the market value of the investment;

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<sup>5</sup> According to the Liquidity Program Adopting Release, evaluating whether an investment strategy is appropriate for an open-end fund will likely entail evaluation of strategies permitted under the new 15% illiquid investment limit that could, although permitted, present significant liquidity risk. Indeed, the Commission stated that "funds that have significant holdings of securities with extended settlement periods may face challenges operating as open-end funds and should take these holdings into account when determining whether the fund's portfolio is appropriate for an open-end fund."

<sup>6</sup> The phrase "convertible to cash" means the ability to be sold, with the sale settled.

- **Less liquid investments:** any investments reasonably expected to be able to be sold or disposed of in current market conditions in seven calendar days or less without significantly changing the market value of the investment, but where the sale or disposition is reasonably expected to settle in more than seven calendar days;
- **Illiquid investments:** any investments not reasonably expected to be able to be sold or disposed of in current market conditions in seven calendar days or less without significantly changing the market value of the investment.

The liquidity categories pertain to current market conditions rather than predictions of how investments may trade under stressed conditions. The requirement to determine whether a sale or disposition will significantly change the market value of the investment does not entail a requirement to re-value or re-price the investment or to precisely estimate market impact.

## ***b. Classification Inputs***

### ***i. Market, Trading and Investment-Specific Considerations***

Classification must be based on information obtained after “reasonable inquiry” and must take into account “relevant market, trading and investment-specific considerations.” Relevant considerations include the: (i) existence of an active market for an asset class or investment, and the exchange-traded nature of an asset class or investment; (ii) frequency of trades or quotes, average daily trading volume; (iii) volatility of trading prices; (iv) bid-ask spreads; (v) standardization and simplicity of an asset class’s or investment’s structure; (vi) (for fixed income securities) maturity and date of issue; and (vii) restrictions on trading and limitations on transfer.

### ***ii. Classification by Asset Class***

Funds are permitted to classify portfolio investments, including derivatives, by asset class rather than on an investment-by-investment basis. Separate classification is required, however, if the fund or its adviser has information about any market, trading or investment-specific considerations that are reasonably expected to significantly affect the liquidity characteristics of the investment relative to other fund holdings in that asset class. Funds should have procedures for classifying investments’ liquidity by asset class, which should “meaningfully distinguish between asset classes and sub-classes” and should also include procedures for updating default classifications based on market, trading and investment-specific considerations.

### ***iii. Market Depth***

The Liquidity Rule requires funds to determine whether trading different portions of a position in a particular investment or asset class, in sizes that the fund would reasonably anticipate trading, is reasonably expected to significantly affect the liquidity of the investment and, if so, this must be taken into account when classifying the liquidity of that investment or asset class. Classifications of *portions* of a position is not contemplated under the Liquidity Rule, and determinations under this provision of the Liquidity Rule “apply to the entirety of the fund’s position in that investment.”

### ***iv. Derivatives***

For derivatives transactions classified as anything other than highly liquid investments, a fund must identify the percentage of the fund’s highly liquid investments that are segregated to cover, or pledged to satisfy margin requirements in connection with, such derivatives transactions. This percentage will be disclosed on Form N-PORT and, when determining whether a fund primarily holds assets that are highly liquid

investments (in the context of the highly liquid investment minimum provisions, discussed below), this percentage must be excluded.

***c. Review of Liquidity Classifications***

A fund must review its portfolio investments' classifications at least monthly in connection with required Form N-PORT reporting and more frequently if changes in relevant market, trading and investment-specific considerations are reasonably expected to materially affect one or more classifications.

***d. Reporting and Disclosure***

Position-level liquidity classification information will be reported on Form N-PORT a non-public basis, while aggregate percentages of a fund's portfolio investments in each liquidity category will be publicly available quarterly with a 60-day delay. The percentage of a fund's highly liquid investments segregated to cover, or pledged to satisfy margin requirements in connection with, derivatives transactions classified as moderately liquid, less liquid or illiquid will also be publicly available quarterly with a 60-day delay.

***3. Highly Liquid Investment Minimum***

The Liquidity Rule requires funds that do not "primarily" hold assets that are highly liquid investments to: (i) determine a highly liquid investment minimum (HLIM) considering the Liquidity Risk Factors, as applicable; (ii) review the HLIM periodically, no less frequently than annually; and (iii) adopt policies and procedures for responding to a "shortfall" of the HLIM (the Shortfall Policies and Procedures). In-Kind ETFs are not subject to this requirement.

During any period where the percentage of the fund's assets that are highly liquid investments is below the HLIM (an HLIM Shortfall), the HLIM may not be changed without approval of the fund's board, including a majority of the independent board members. Funds are not prohibited from acquiring assets that are not highly liquid investments during an HLIM Shortfall. The Commission stated that funds should consider HLIM adjustments if they encounter stressed market conditions that could result in unusual levels of liquidity risk and should review their HLIMs more frequently than annually if circumstances warrant.

***a. Liquidity Risk Factors***

According to the Liquidity Program Adopting Release, a higher HLIM is generally expected for funds: (i) with relatively less liquid portfolio investments; (ii) with strategies expected to have greater volatility of flows (such as alternative funds and emerging market debt funds) and leveraged strategies; (iii) with relatively concentrated shareholder bases; (iv) with policies to meet redemption requests the next business day; (v) that are sold through channels that attract investors with more volatile or unpredictable flows; and (vi) that do not have substantial visibility into their shareholder bases or that are uncertain about changing market conditions likely to materially affect net redemptions. Additional considerations when setting the HLIM include (i) highly liquid assets segregated for cover or margin purposes may be unavailable to meet redemptions, and (ii) holdings of cash and cash equivalents, and access to a line of credit or other funding source, may indicate decreased liquidity risk.

***b. Shortfall Policies and Procedures***

Shortfall Policies and Procedures must require that the Program Administrator (as defined below): (i) report to the fund's board, no later than its next regularly scheduled meeting, with a brief explanation of the causes and extent of any HLIM Shortfall, and any actions taken in response; and (ii) if the HLIM Shortfall lasts more than seven consecutive calendar days, report to the fund's board within one business day with an

explanation of how the fund plans to restore its HLIM within a reasonable period of time. HLIM Shortfalls lasting more than seven consecutive calendar days must also be reported on new Form N-Liquid.

***c. Periodic (Annual) Review of HLIM***

The HLIM must be reviewed at least annually. The Commission suggested that funds may wish to adopt procedures specifying circumstances that would prompt more frequent reviews of the HLIM.

***d. Funds “Primarily” Holding Assets that are Highly Liquid Investments***

Funds that “primarily” hold assets that are highly liquid investments (Primarily Highly Liquid Funds) are not subject to the HLIM requirements. The Liquidity Rule does not specify what it means to be a Primarily Highly Liquid Fund, but the Commission stated that “if a fund held less than 50% of its assets in highly liquid investments it would be unlikely to qualify as ‘primarily’ holding assets that are highly liquid investments.” The Commission expects Primarily Highly Liquid Funds’ liquidity risk management programs to address how such funds determined that they are Primarily Highly Liquid Funds. As noted above, for purposes of determining whether a fund is a Primarily Highly Liquid Fund, the fund must exclude from its calculations the percentage of fund assets that are highly liquid investments segregated to cover, or pledged to satisfy margin requirements in connection with, derivatives transactions classified as moderately liquid, less liquid and illiquid investments. Also, portfolio drift or changes in investment strategies may result in a fund ceasing to be a Primarily Highly Liquid Fund and thus, becoming subject to the HLIM requirements.

***e. Reporting and Disclosure***

On a non-public basis, each of the following must be reported on Form N-PORT: (i) the HLIM; (ii) (if the HLIM has changed during the reporting period) any prior HLIMs established during the reporting period; and (iii) the number of days in the reporting period during which a fund experienced an HLIM Shortfall.

**III. 15 % Limit on Illiquid Investments**

***1. General***

The Liquidity Rule prohibits the acquisition by a fund (including an In-Kind ETF) of any illiquid investment if, immediately after the acquisition, the fund would have invested more than 15% of its net assets in illiquid investments<sup>7</sup> that are “assets.”<sup>8</sup> The Liquidity Rule effectively codifies in a 1940 Act rule the Commission’s historical limit on investments in illiquid assets and supersedes previous SEC guidance regarding illiquid investment limits.

The Liquidity Rule requires the fund to consider relevant market, trading and investment-specific considerations, as well as market depth, when classifying a fund’s investments as illiquid investments for purposes of both the general classification framework described above as well as for purposes of the 15%

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<sup>7</sup> Under the Liquidity Rule, an “illiquid investment” is defined as any investment that the fund reasonably expects cannot be sold or disposed of in current market conditions in seven calendar days or less without the sale or disposition significantly changing the market value of the investment.

<sup>8</sup> Rule 22e-4(b)(1)(iv) specifically refers to investments that are “assets,” in order to clarify that the limitation on illiquid investments applies to investments with positive values, and that the limitation does not permit netting illiquid investments that have negative values against illiquid investments that have positive values.

limit. The SEC acknowledged that, because of this change, “some funds may determine that a greater percentage of holdings are illiquid.”

## ***2. Breaches of the 15% Limit***

If a fund’s portfolio includes illiquid investments in excess of the 15% limit, the fund may not acquire additional illiquid investments. The Liquidity Rule will not require a fund to divest illiquid investments if the fund’s holdings of illiquid investments exceed the 15% limit. However, the Commission stated its belief that “a fund should not be permitted to exceed the 15% limit on illiquid investments for an extended period of time without board oversight,” and, therefore, exceeding the 15% limit will trigger the following disclosure and board reporting obligations: (i) the fund must confidentially report to the Commission within one business day on Form N-LIQUID that the fund’s portfolio exceeds the 15% limit; and (ii) the Program Administrator must report such occurrence to the fund’s board within one business day, explaining the extent and causes of the occurrence, as well as providing a proposed plan to bring illiquid investments to or below the 15% limit “within a reasonable amount of time.” Furthermore, if, after 30 days (and each 30-day period thereafter), the percentage of a fund’s net assets in illiquid investments continues to exceed the 15% limit, the fund’s board (including a majority of independent board members) is required to assess whether the plan to bring illiquid investments to or below the 15% limit continues to be in the fund’s best interest.

## **IV. Board Oversight**

The Liquidity Rule imposes new oversight responsibilities on a fund’s board, including: (i) initially approving the fund’s written program; (ii) approving the designation of the person, or a group of persons, responsible for administering the program (Program Administrator); and (iii) reviewing (at least annually) a written report prepared by the Program Administrator. In addition, as discussed below, the board has certain non-recurring oversight responsibilities with respect to a fund’s HLIM and investments in illiquid investments. Importantly, despite these new responsibilities, the Commission confirmed that the board’s role is one of general oversight and that board members should exercise their reasonable business judgment to oversee the “adequacy and effectiveness” of a fund’s liquidity risk management program.

### ***1. Approving the Program Administrator***

Under the Liquidity Rule, the board (including a majority of independent board members) is responsible for approving the designation of the fund’s Program Administrator. A fund’s Program Administrator could be the fund’s investment adviser or sub-adviser, a specific fund officer or a group of fund officers. Although portfolio managers may comprise part of a committee or group approved as the Program Administrator, to ensure a sufficient level of separation between a fund’s portfolio management and risk management, the Program Administrator cannot be assigned solely to portfolio managers.<sup>9</sup> A fund may also delegate administration of a part of its program to third-party service providers, subject to appropriate oversight by the fund.

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<sup>9</sup> According to the Commission, “a fund generally should consider the extent of influence portfolio managers may have on administration of the program, and seek to provide independent voices and administration of the program as a check on any potential conflicts of interest to the extent appropriate.” Nonetheless, the SEC noted that a fund’s Program Administrator “might wish to consult with the fund’s portfolio manager, traders, risk managers and others as necessary or appropriate in administering a fund’s liquidity risk management program.”

## ***2. Approving the Liquidity Risk Management Program***

The board (including a majority of independent board members) must initially approve a fund's written liquidity risk management program. In doing so, the board may rely on summaries of the program provided by the Program Administrator, legal counsel or others with knowledge of how the program would be administered. The summary should educate the board as to the "salient features" of the program and help the board members understand how the program would address a fund's liquidity risk.

## ***3. Reviewing the Annual Report***

The board (including a majority of independent board members), must also review a written report, to be provided by the Program Administrator no less frequently than annually, that details the operation of a fund's liquidity risk management program. To assist the board in evaluating the adequacy and effectiveness of the program, the report should also include a description of:

- The operation of the fund's HLIM over the past year, if applicable;
- Any occurrences throughout the year when the fund has exceeded the 15% limit on illiquid investments; and
- Any material changes to the program.

## ***4. Incident Driven Board Reporting***

In addition to the standard review and approval responsibilities outlined above, the board has certain additional responsibilities for overseeing compliance with the HLIM and illiquid investments limit.

### ***a. Highly Liquid Investment Minimum***

In situations where the Program Administrator seeks to make a change to a fund's HLIM at a time when the fund's portfolio is below the pre-established minimum, the board (including a majority of independent board members) is required to approve such change. Further, a fund's board is responsible for reviewing additional reports pursuant to the fund's Shortfall Policies and Procedures. If at any time a fund's investments fall below the fund's HLIM, the board must receive a report of the occurrence at the next scheduled board meeting. However, should a fund's investments fall below its HLIM for more than seven consecutive days, the Program Administrator must report to the board within one business day.

### ***b. Illiquid Investments***

The Program Administrator must provide the board with a report within one business day if a fund's illiquid investments exceed the 15% limit on illiquid investments. In the report, the Program Administrator must explain the cause and extent of the fund exceeding the 15% limit, as well as provide a plan to bring the percentage of the fund's assets in illiquid investments in compliance with the 15% limit. The board has additional responsibilities if a fund's illiquid investments remain above the 15% limit for more than 30 consecutive days (and each 30-day period thereafter).

## **V. In-Kind Redemption Procedures**

Currently, many funds reserve the right to satisfy a redeeming shareholder's interest in a fund by distributing a portion of its portfolio securities instead of cash. These so-called "in-kind" redemptions allocate the transaction costs of liquidating portfolio securities to the redeeming shareholder instead of the remaining shareholders. Under the Liquidity Rule, funds that engage in, or reserve the right to engage in, in-kind redemptions, including In-Kind ETFs, are required to establish policies and procedures that address

the process for and the circumstances under which they may engage in in-kind redemptions. According to the Commission, effective and well-designed in-kind redemption policies and procedures should contemplate, among other things: (i) the particular types of events or conditions (e.g., stressed market conditions) that would cause a fund to engage in in-kind redemptions; (ii) whether in-kind redemptions would be used only for large redemption requests or only for requests over a certain size; (iii) the ability of shareholders to receive in-kind redemptions; (iv) whether holdings through omnibus accounts pose any unique issues; (v) other potential operational issues, which may include implementing in advance a securities transfer process with certain large shareholders; and (vi) whether portfolio securities would be distributed on a *pro rata* or a non-*pro rata* basis.<sup>10</sup>

## **VI. Guidance on Cross-Trades**

The Liquidity Program Adopting Release provided guidance on the use of cross-trades, but does not explicitly amend Rule 17a-7 under the 1940 Act, which is the exemptive rule pursuant to which cross-trades are effected between funds and certain affiliates. While the Commission recognized that a security's liquidity, taken alone, is not determinative of its eligibility under Rule 17a-7, the Liquidity Program Adopting Release also noted that it may be more difficult to determine that the terms of a cross-trade are fair and reasonable when less liquid assets are involved. In connection with this observation, the SEC noted that it "it may be prudent for advisers to subject less liquid assets to careful review (and potentially even a heightened review compared to other more liquid assets) before" cross-trading less liquid assets. The Commission also noted that a fund's compliance policies and procedures (as required under Rule 38a-1) generally should contemplate how the fund would satisfy the terms and conditions of Rule 17a-7 with respect to less liquid assets. In addition, the Commission suggested that funds consider, among other things: (i) specifying in their policies and procedures "the sources of the readily available market quotations to be used to value the assets"; and (ii) establishing a mechanism for assessing the quality of quotations provided by dealers. The Commission also noted that "'[i]ndications of interest' and 'accommodation quotes,' may not necessarily reflect the current market values of the securities and thus are not 'market quotations' or 'market values' for the purposes of Rule 17a-7."

## **VII. Treatment of Exchange-Traded Funds Under the Liquidity Rule**

In the Liquidity Program Adopting Release, the Commission agreed with commenters that various characteristics of ETFs necessitate a different approach to assessing liquidity risks, including: (i) the role of authorized participants in the creation and redemption process; (ii) the use by many ETFs of in-kind transfers for purchases and redemptions in place of cash; and (iii) the exchange-traded nature of ETF shares. While the Liquidity Rule does not exempt ETFs, the SEC adopted a tailored approach for ETFs to utilize when implementing a liquidity risk management program.<sup>11</sup> As part of the tailored approach for ETFs, the Commission has codified a classification known as an "In-Kind ETF," which is an ETF that meets redemptions through in-kind transfers of securities, positions and assets other than a *de minimis* amount of

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<sup>10</sup> According to the Liquidity Program Adopting Release, if a fund provides for in-kind redemptions on a non-*pro rata* basis, effective policies and procedures should contemplate whether the selection, valuation and distribution of portfolio securities are fair to both redeeming and remaining shareholders, which may include an assessment of tax consequences for shareholders. These policies and procedures should also address odd lots, illiquid securities or securities that have transfer restrictions.

<sup>11</sup> The Commission justified requiring ETFs to assess and manage liquidity risk in a manner similar to other open-end funds, even in the case of In-Kind ETFs (which do not need to sell portfolio securities to satisfy redemptions), by stating that illiquidity of an ETF's underlying portfolio securities could result in widening of ETF shares' bid-ask spread or result in market prices that differ materially from the NAV of EFT shares. Furthermore, the Commission stated that portfolio illiquidity could impact a market maker's ability or willingness to engage in the arbitrage function.

cash, and which publishes its portfolio holdings daily. ETFs that comply with the definition of an In-Kind ETF are exempt from the Liquidity Rule's requirements related to portfolio liquidity classifications and the HLIM.

### ***1. Applicable Requirements for All ETFs***

Under the Liquidity Rule, ETFs will be required to adopt a liquidity risk management program. However, ETFs will be required to consider two additional factors when assessing their liquidity risks. First, ETFs will need to assess the relationship between an ETF's liquidity and the manner in which its shares trade, including an analysis of bid-ask spread, the efficiency of the arbitrage process and the level of engagement by market participants. Second, an ETF must evaluate the composition of its basket of securities and the effect the basket has on the ETF's liquidity. The SEC asserted that if the securities in the basket are not a *pro rata* share of the ETF's portfolio, this could impact the overall liquidity profile of the fund. In addition, as part of new annual reporting obligations on Form N-CEN, an ETF (including an In-Kind ETF) will be required to report "the average percentage value of creation units purchased and redeemed both with in-kind securities and assets and with cash, during the reporting period."

### ***2. Considerations Specific to In-Kind ETFs***

The Liquidity Rule exempts In-Kind ETFs from the portfolio liquidity classification requirement and the HLIM requirement.<sup>12</sup> Compliance with the In-Kind ETF definition requires ongoing monitoring of the amount of cash used to settle each redemption transaction, as well as an obligation to provide daily transparency of a fund's holdings.<sup>13</sup> An In-Kind ETF must report its classification as an "In-Kind ETF" annually on Form N-CEN.

The SEC noted that ETFs which redeem more than a *de minimis* amount in cash can have liquidity risks substantially similar to mutual funds. While the Commission noted that such *de minimis* amount must be determined in accordance with written policies and procedures developed by the In-Kind ETF (as described further below), the Liquidity Program Adopting Release provided the following examples of when the Commission would consider the amount of cash to be a *de minimis* amount:

- Using cash as a small "balancing amount" to make up any difference between the NAV of a creation unit and the market value of the aggregate basket of securities;
- Using cash as part of a redemption basket to correspond to the amount of cash held by the ETF; and
- Using cash when a security is not eligible for in-kind transfer.

The SEC stated that should an ETF deliver solely cash to any authorized participant in a single redemption transaction, the ETF would not qualify as an In-Kind ETF. However, in the event that an ETF fails to qualify for the In-Kind ETF exemption at a given point in time, it may be able to conclude that it qualifies in later years.

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<sup>12</sup> Although In-Kind ETFs are exempt from the Liquidity Rule's liquidity classification requirements, In-Kind ETFs are nevertheless subject to the 15% limit on illiquid investments. Consequently, an In-Kind ETF will be required to classify which of its net assets fall within the fourth category of the liquidity classification, an "illiquid investment," for purposes of the 15% limit.

<sup>13</sup> As a practical effect of adopting the Liquidity Rule, the Commission is codifying a condition of many exemptive orders received by ETF issuers; this operational obligation will be required of ETF issuers that are not currently subject to this condition in their respective exemptive orders.

According to the Liquidity Program Adopting Release, an In-Kind ETF “generally should describe in its written policies and procedures for its liquidity risk management program, to the extent applicable, how the fund analyzes the ability of the ETF to redeem in-kind in all market conditions such that it is unlikely to suddenly fail to continue to qualify for this exception to the classification and highly liquid investment minimum requirements, the circumstances in which the In-Kind ETF may use a *de minimis* amount of cash to meet a redemption, and what amount of cash would qualify as such.” In addition, according to the Liquidity Program Adopting Release, “an In-Kind ETF generally should also describe how the ETF will manage and/or approve any portion of a redemption that is paid in cash and document the ETF’s determination that such a cash amount is *de minimis*.”

## **VIII. Treatment of Unit Investment Trusts Under the Liquidity Rule**

Unit investment trusts (UITs) are not required to adopt a liquidity risk management program, however, the Liquidity Rule requires UITs to conduct a limited liquidity review. On or before the UIT’s initial date of deposit, the UIT’s principal underwriter or depositor must determine that the liquidity of the securities deposited into the UIT are consistent with the liquidity and redeemable characteristics of the securities the UIT will issue. The Commission indicated in the Liquidity Program Adopting Release that the expected analysis of a UIT issuer should resemble the process for determining whether a fund’s holding of illiquid investments is consistent with the 15% limit on illiquid investments. This initial evaluation is consistent with the unmanaged structure of a UIT and comparable to an open-end fund’s determination of whether the fund’s strategy is appropriate for an open-end fund.

## **IX. Swing Pricing**

Under the Swing Pricing Amendments, funds (excluding MMFs and ETFs) would be permitted, but not required, to use swing pricing as part of their liquidity risk management programs in order to mitigate the risk that shareholder purchase and redemption activities could dilute the value of fund shares. Swing pricing refers to a mechanism that would adjust the NAV of a fund’s shares to effectively pass on the costs associated with purchases or redemptions of fund shares to the purchasing or redeeming shareholder.

Before a fund can utilize swing pricing, it will be required to establish policies and procedures that, among other things, designate an amount (swing factor) by which the fund will adjust its NAV if the level of net purchases into or net redemptions from the fund exceed a predetermined percentage of the fund’s NAV (swing threshold). In addition, the swing pricing policies and procedures will be required to: (i) specify the process for determining the swing threshold(s) and swing factor(s); and (ii) provide for the board’s review of periodic reports prepared by the persons responsible for administering swing pricing.

### **1. Swing Threshold**

A fund’s swing threshold is defined as “the amount of net purchases into or net redemptions from a fund, expressed as a percentage of the fund’s net asset value, which triggers the initiation of swing pricing.” In-kind purchases and redemptions would be excluded from this calculation. According to the Swing Pricing Adopting Release, a fund’s swing threshold “should generally reflect the estimated point at which net purchases or net redemptions would trigger the fund’s investment adviser to trade portfolio assets in the near term, to a degree or of a type that may generate material liquidity or transaction costs for the fund.” To assist a fund in predicting the levels of purchases and redemptions that would cause the fund to incur material costs, the Swing Pricing Amendments would require the fund to consider, at a minimum, the following factors:

- The size, frequency and volatility of historical net purchases or net redemptions of fund shares during normal and stressed periods;

- The fund’s investment strategy and the liquidity of the fund’s portfolio assets;
- The fund’s holdings of cash and cash equivalents, as well as borrowing arrangements and other funding sources; and
- The costs associated with transactions in the markets in which the fund invests.

The determination of a fund’s swing threshold must be made pursuant to policies and procedures approved by the fund’s board (including a majority of independent board members). In addition, the fund’s board would be required to periodically review a report prepared by the persons responsible for administering swing pricing that describes, among other things, their assessment of the fund’s swing threshold(s). Any change to a fund’s swing threshold(s) will require approval by the fund’s board.

## ***2. Swing Factor***

Under the Swing Pricing Amendments, a fund’s swing factor is defined as the “amount, expressed as a percentage of the fund’s NAV, by which the fund adjusts its NAV when the fund’s net purchases or net redemptions cross the fund’s swing threshold.” According to the Commission, this amount should reflect the estimated costs associated with purchase and redemption activity that could dilute the value of existing shareholders’ interests in the fund. The Swing Pricing Amendments require a fund’s swing pricing policies and procedures to describe the process for determining the fund’s swing factor. The Swing Pricing Amendments contain an explicit requirement that the swing factor be “reasonable in relationship to near-term costs.” According to the Swing Pricing Adopting Release, these near-term cost considerations will be limited to: (i) spreads; (ii) transaction-related fees and charges arising from effecting portfolio transactions as a result of the net redemptions or net subscriptions; and (iii) borrowing-related costs incurred by the fund in order to meet a redemption request.

## ***3. Swing Factor Upper-Limit***

The Swing Pricing Amendments will require a fund to establish and disclose a board-approved swing factor upper limit, which cannot exceed two percent of the fund’s NAV per share. The Commission stated its belief in the Swing Pricing Adopting Release that limiting the swing factor will help mitigate volatility and tracking error issues that could arise from the use of swing pricing.

## ***4. Application of the Swing Factor***

The Swing Pricing Amendments require a fund to adjust its NAV whenever net purchases *or* net redemptions exceed the swing threshold. If a fund’s swing threshold is breached, the swing factor will be applied equally to all purchasing and redeeming shareholders, regardless of the size of their orders or whether such orders would likely create material trading costs for the fund. Funds that offer multiple share classes must apply the swing factor equally to all of their share classes. In recognition of the operational difficulties of implementing swing pricing, the Commission delayed the effectiveness of the Swing Pricing Amendments to “allow for the creation of industry-wide operational solutions in a more efficient manner.” According to the Swing Pricing Adopting Release, “providing an extended effective date may more effectively facilitate the adoption of swing pricing.”

## ***5. Board Considerations***

A fund’s board (including a majority of the independent board members) will have to initially approve the fund’s swing pricing policies and procedures. The fund’s board must review a report prepared by the persons responsible for administering swing pricing. The report must address, at a minimum, the following:

- The Swing-Pricing Administrator’s (as defined below) assessment of the swing pricing policies and procedures, and the effectiveness of their implementation;
- Any material changes to the swing pricing policies and procedures during the review period; and
- The Swing-Pricing Administrator’s review and evaluation of the fund’s swing threshold(s), swing factor(s) and swing factor upper limit.

Under the Swing Pricing Amendments, a fund’s board must designate the fund’s investment adviser or officer(s) responsible for administering fund’s swing pricing policies/procedures (a Swing-Pricing Administrator). The Commission noted that a fund may wish establish a swing pricing committee that would be responsible for administering the policies and procedures.

## **X. Disclosure and Reporting**

### **1. Amendments to Form N-1A**

The final rule adopts the following amendments to Item 11 of Form N-1A:

- Funds must disclose the number of days typically expected, or an estimated range of days, in which they will pay out redemption proceeds. The disclosed payout timing must be based on the method of payment (e.g., by check, wire, or automated clearing house) chosen by the redeeming shareholder, rather than the distribution channel through which the redeeming shareholder generally transacts.
- Funds must describe the methods they typically expect to use to satisfy redemption requests (e.g., sale of portfolio securities, cash reserves, lines of credit, interfund lending, or redemptions in kind), as well as whether such methods will be used regularly or only in stressed market conditions.

Funds that decide to use swing pricing would be required to include an explanation in their registration statements regarding swing pricing, the circumstances in which the funds will use swing pricing and the effects of initiating swing pricing. In addition, funds that use swing pricing will be required to disclose the fund’s swing factor upper limit(s).

### **2. Amendments to Form N-CEN**

The Commission amended Part C of Form N-CEN to require funds to report certain information regarding lines of credit, interfund lending and borrowing and swing pricing. A fund must disclose: (i) whether it has an available line of credit; (ii) whether each available line of credit is committed or uncommitted; (iii) the size of each line of credit (in U.S. dollars); (iv) the name of the institution providing the line(s) of credit; and (v) whether other funds in the fund complex may access the line(s) of credit and the names of such funds. There are also additional disclosure requirements for any fund that draws on its line(s) of credit during the relevant reporting period.

If a fund engages in interfund lending and/or borrowing during any given reporting period, the fund must disclose the average amount of the loan when the loan was outstanding and the period of time the loan was outstanding. Lastly, a fund will be required to disclose whether it used swing pricing during the relevant reporting period.

### **3. New Reporting Form N-LIQUID**

Funds will be required to file reports with the Commission on new Form N-LIQUID when certain liquidity-related events occur. These reports will be non-public and will be required within one business day of the occurrence of an event specified in the form. Events triggering disclosure include:

- When more than 15% of fund net assets are, or become, illiquid;<sup>14</sup>
- If illiquid investments that are assets previously exceeded 15% of fund net assets have changed so that such investments are less than or equal to 15% of fund net assets;<sup>15</sup> and
- An HLIM Shortfall lasting more than seven consecutive calendar days.<sup>16</sup>

#### 4. *Financial Statement Reporting/Financial Highlights*

The impact of swing pricing will need to be reflected in a fund's financial statements, including the fund's balance sheet and the notes to the financial statements. With respect to the notes to the financial statements, the Commission will require a fund to describe the fund's use of swing pricing during the relevant reporting period, including the effects of swing pricing on the fund's financial statements.

### XI. Recordkeeping

Funds (including In-Kind ETFs) must comply with the following recordkeeping requirements, which the Commission expects to be evaluated by its examination staff:

- ***Liquidity Risk Management Policies and Procedures.*** These policies and procedures must be maintained for a period of at least five years in an easily accessible place.
- ***Board Materials.*** Any materials provided to the board in connection with its initial approval of a fund's liquidity risk management program must be maintained for a period of at least five years, the first two years in an easily accessible place.
- ***Reports on Adequacy of the Program.*** Reports on the adequacy of the program and its implementation must be maintained for a period of at least five years, the first two years in an easily accessible place.
- ***Highly Liquid Investment Minimum.*** If applicable, a written record of how a fund determined its HLIM (and any adjustments thereto) must be maintained for a period of at least five years, the first two years in an easily accessible place.
- ***Shortfall Policies and Procedures.*** If applicable, any materials provided to the board in connection with any HLIM Shortfall must be maintained for a period of at least five years, the first two years in an easily accessible place.
- ***Swing Pricing Policies and Procedures.*** These policies and procedures must be maintained for a period of at least six years in an easily accessible place. A fund also will be required to keep a copy of all supporting documents regarding any adjustments to the fund's NAV as a result of its swing pricing policies and procedures for a period of at least six years, the first two years in an easily accessible place. In addition, a fund will be required to maintain copies of any reports provided to the board by the

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<sup>14</sup> This event will trigger disclosure of the date(s) of such event, the current percentage of net assets that are illiquid investments and certain identifying information about the illiquid investments (name of issuer, title of issue or description of investment, CUSIP (if any), one other identifier if available) as well as the percentage of fund net assets attributable to that investment.

<sup>15</sup> This event will trigger disclosure of the date(s) of such event and the current percentage of net assets that are illiquid investments.

<sup>16</sup> This event will trigger disclosure of the date(s) on which fund holdings of assets that are highly liquid investments fell below the HLIM.

persons responsible for administering swing pricing for a period of at least six years, the first two years in an easily accessible place.

## **XII. Compliance and Effective Dates**

- ***Liquidity Risk Management Program Requirements.*** A fund's compliance date depends on its asset size and/or the asset size of its related fund complex. For larger funds that, combined with other funds in the same complex, have net assets of \$1 billion or more as of the end of the most recent fiscal year, the compliance date will be *December 1, 2018*. For smaller funds that, combined with other funds in the same complex, have net assets below \$1 billion as of the end of the most recent fiscal year, the compliance date will be *June 1, 2019*.
- ***Disclosure and Reporting Requirements.*** All initial registration statement filings and post-effective amendments that are annual updates to effective registration statements must comply with the proposed amendments to Form N-1A by *June 1, 2017*. Similar to the compliance date for the liquidity risk management program requirements, the compliance date for the amendments to Form N-CEN varies based on the fund's asset size. For larger funds, the compliance date will be *December 1, 2018*; for smaller funds, the compliance date will be *June 1, 2019*.
- ***Swing Pricing.*** Based on operational concerns raised by commenters, the Commission delayed the effective date of the Swing Pricing Amendments until two years after the final rules are published in the Federal Register.