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# To the Point

**SEC — proposed rules**

## SEC proposes liquidity risk rules for mutual funds and ETFs

Funds would have to establish a minimum threshold for assets that can be convertible to cash within three business days.

### What you need to know

- The SEC proposed requiring that all open-end mutual funds (excluding money market funds) and exchange-traded funds implement a liquidity risk management program and enhance disclosures regarding fund liquidity and redemption practices.
- The SEC also proposed giving mutual funds the option to use swing pricing to adjust their net asset value for costs associated with satisfying requests for shareholder purchases or redemptions (e.g., costs of trading portfolio assets) in certain circumstances.
- Comments are due 90 days after the proposal is published in the Federal Register.

### Overview

The Securities and Exchange Commission (SEC) proposed rules for all open-end mutual funds (except for money market funds) and exchange-traded funds (ETFs) that are intended to minimize the risk that funds hit with a high number of redemptions during periods of market turmoil may not be able to satisfy their obligations without negatively affecting the fund's net asset value (NAV).

The SEC noted in the proposal that the fund industry has grown significantly in the past 20 years and that funds today pursue more complex investment strategies than in the past. These include fixed income and alternative investment strategies that focus on less liquid asset classes that may be hard to sell in times of market stress.

Mutual funds allow investors to redeem their shares daily and are required by law to pay shareholders within seven days. ETFs allow daily redemptions only for certain large market participants.

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## Key considerations

### Liquidity risk management program

The proposal would require all open-end mutual funds (except money market funds) and ETFs to adopt and implement a liquidity risk management program designed to assess and manage their liquidity risk.

The proposed rules would require funds to classify assets into one of six liquidity categories based on how long they believe it would take to convert the asset to cash at a price that doesn't materially affect the asset's value immediately prior to sale. The categories would range from one business day to more than 30 calendar days.

Funds also would have to determine a minimum percentage of net assets that must be invested in assets that can be converted to cash within three business days at a price that does not materially affect the value of the assets immediately prior to sale (three-day liquid asset minimum). A fund's board would be required to approve the fund's liquidity risk management program, including the fund's three-day liquid asset minimum percentage. Funds also would be required to assess and periodically review their liquidity risk based on certain factors.

The proposal also would codify the 15% limit on illiquid assets included in current SEC guidelines. A fund would not be able to acquire any asset that cannot be sold in the ordinary course of business within seven days at approximately its fair value, as recorded by the fund, if acquiring the asset would bring the total value of these illiquid assets to over 15% of the fund's net assets.

Funds would be allowed to use swing pricing to manage the dilutive effects of large subscriptions or redemptions.

### Swing pricing

The proposed rules would provide the option for open-end funds, except for ETFs and money market funds, to establish policies and procedures to adjust their NAV by swing factors expressed as a percentage of their NAV when the level of net purchases or net redemptions exceeds a specified percentage of their NAV.

Funds could use what is known as swing pricing to pass along to purchasing and redeeming shareholders the costs of trading portfolio assets while protecting other shareholders of the fund. A fund's board would have to approve the use of swing pricing policies and procedures.

If implemented, swing pricing policies and procedures would affect funds' financial statements and disclosures as follows:

- Funds would be required to disclose the adjusted NAV in their balance sheets and statements of changes in net assets if swing pricing has been used.
- Capital share transactions disclosed in the statement of changes in net assets would be based on the adjusted NAV if swing pricing has been used.
- NAV-based performance fees would be based on the adjusted NAV if swing pricing has been used.
- The per-share effect of swing pricing would be disclosed below the total distributions line in a fund's financial highlights, and adjusted NAV would be used when calculating total return if swing pricing has been used.
- Notes to the financial statements would include a disclosure of general methods used in determining whether the fund's NAV per share will swing, whether the fund's NAV per share has swung during the year, and a general description of the effects of swing pricing on the fund's financial statements.

## How we see it

The SEC proposal would allow funds to determine whether the potential benefits of swing pricing outweigh the potential costs to individual investors, particularly in circumstances where purchases and redemptions by smaller investors wouldn't trigger swing pricing on their own but may coincide with those of large investors whose purchases and redemptions would trigger swing pricing on their own.

## Amendments to forms

The SEC proposed amending the registration form used by open-end investment companies (Form N-1A) and two new forms the SEC recently proposed (Forms N-PORT and N-CEN) as follows:

- New disclosures on Form N-1A would include (1) the number of days in which the fund will pay redemption proceeds to shareholders and how the fund will meet redemption requests and (2) what would trigger swing pricing and what its effects would be, if applicable. A fund that has line of credit agreements would have to file them in an exhibit.
- Form N-PORT would require that a fund disclose the liquidity classification of each portfolio asset and its three-day liquid asset minimum and identify each asset subject to the 15% limit on illiquid assets.
- Form N-CEN would require funds to answer certain questions about their use of lines of credit, interfund lending, interfund borrowing and swing pricing and would require ETFs to report whether they require that an authorized participant post collateral in connection with the purchase or redemption of ETF shares during the reporting period.