SEC Adopts New Rules Mandating Open-End Fund Liquidity Risk Management Programs and Permitting Swing Pricing

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Introduction

On October 13, 2016, the Securities and Exchange Commission (the "SEC") adopted new Rule 22e-4 under the Investment Company Act of 1940 (the "1940 Act"), which will require registered open-end investment companies (including open-end exchange-traded funds ("ETFs") but excluding money market funds) to establish comprehensive liquidity risk management programs comprised of policies and procedures designed to address specified criteria.[1] The SEC also adopted a new confidential reporting requirement to notify the SEC when a fund's liquidity level exceeds 15 percent of net assets or when certain funds' highly liquid investments fall below a stated minimum. The new rule establishes additional board responsibilities, and requires the board to appoint either the fund's investment adviser or one or more fund officers as being responsible for administering the liquidity risk management program. In addition, the SEC adopted certain related recordkeeping requirements, as well as changes to Form N-1A and new Forms N-CEN and N-PORT to require certain disclosures and reporting regarding fund liquidity and liquidity risk management (collectively, the "Liquidity Rules").

On October 13, 2016, the SEC also adopted an amendment to Rule 22c-1 under the 1940 Act that will permit, but not require, open-end funds (excluding ETFs and money market funds) to use "swing pricing," a mechanism under which a fund adjusts the net asset value per share at which purchases and redemptions are effected to mitigate the dilutive effect such activity may have on the value of fund shares.[2] The new rule imposes additional responsibilities on the board of any fund that adopts swing pricing, and requires the board to appoint either the fund's investment adviser or one or more fund officers as being responsible for administering swing pricing. The SEC also adopted certain related recordkeeping requirements, as well as changes to Form N-1A, Regulation S-X and new Form N-CEN to require disclosure of certain matters relating to swing pricing (collectively, the "Swing Pricing Rules").

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1 Investment Company Liquidity Risk Management Programs, Investment Company Act Release No. 32,315 (Oct. 13, 2016) (the "Liquidity Rules Adopting Release").

2 Investment Company Swing Pricing, Investment Company Act Release No. 32,316 (Oct. 13, 2016) (the "Swing Pricing Adopting Release").

The SEC proposed the Liquidity Rules and Swing Pricing Rules in September 2015.[3] While the Swing Pricing Rules were adopted largely as proposed, the final Liquidity Rules, in response to industry comments, reflect significant changes from the proposed rules.

Compliance Dates

Liquidity Rules. Funds in groups of related investment companies with $1 billion or more in net assets as of the end of the most recent fiscal year will be required to comply with the Liquidity Rules by December 1, 2018; funds in groups of related investment companies with less than $1 billion in net assets as of the end of the most recent fiscal year will be required to comply by June 1, 2019.

Swing Pricing Rules. The effective date for the Swing Pricing Rules will be 24 months after the Swing Pricing Adopting Release is published in the Federal Register. The delayed effective date is intended to allow for the creation and implementation of efficient and cost-effective solutions to the operational challenges presented by swing pricing.

Liquidity Rules

Background

Section 22(e) of the 1940 Act prohibits funds from postponing the date of payment or satisfaction upon redemption of redeemable securities for more than seven days. For nearly a half century, the SEC has cited this requirement as a basis for issuing guidance on fund liquidity. Current SEC guidance provides that open-end funds should limit investments in illiquid securities to no more than 15 percent of net assets, at the time of the acquisition of an illiquid security.[4] For this purpose, the SEC has defined "illiquid security" as any asset that cannot be sold or disposed of in the

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3 Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release, Investment Company Act Release No. 31,835 (Sept. 22, 2015) (the "Proposing Release").

4 In 1969, the SEC, citing both valuation and liquidity concerns, issued guidance stating that it was "of the view that a prudent limit on any open-end company's acquisition of restricted securities, or other assets not having readily available market quotations, would be 10 per cent" of a fund's assets. Statement Regarding "Restricted Securities," Investment Company Act Release No. 5847 (Oct. 21, 1969) (the "1969 Restricted Securities Release"). In 1992, the SEC increased the limit on illiquid securities from 10 percent to 15 percent of net assets, for the stated purpose of allowing open-end funds to have more flexibility to invest in the illiquid securities of small businesses, in an effort to attempt to provide small businesses with better access to the capital markets. Revisions of Guidelines to Form N-1A, Investment Company Act Release No. 18,612 (Mar. 12, 1992).

ordinary course of business within seven days at approximately the price at which the fund has valued the investment.[5]

The SEC has provided guidance on what securities may be treated as liquid and illiquid for purposes of the 15 percent limit. The SEC originally took the position that restricted securities generally should be considered illiquid.[6] In a 1990 release, the SEC modified this position with respect to securities eligible for resale pursuant to Rule 144A under the Securities Act of 1933 (the "Securities Act").[7] Under this guidance, the liquidity of a Rule 144A security is a question of fact to be determined by a fund's board based on the trading market for the security.[8] With respect to foreign securities, the SEC has stated that such securities would not necessarily be illiquid despite being restricted securities under the Securities Act if they can be freely traded in a foreign securities market and all of the facts and circumstances otherwise support a determination that the securities are liquid.[9]

The SEC and staff have also identified the following securities as illiquid or potentially illiquid:

- Securities, including fixed-income securities and real estate interests, for which there is no established market;
- Private equity securities;
- Securities issued by small businesses;
- Bank loans, loan participations and other investments with extended settlement periods;

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[5] *See*, *e.g.*, Acquisition and Valuation of Certain Portfolio Instruments by Registered Investment Companies, Investment Company Act Release No. 14,983 (Mar. 17, 1986).

[6] *See* 1969 Restricted Securities Release.

[7] Resale of Restricted Securities; Changes to Method of Determining Holding Period of Restricted Securities Under Rules 144 and 145, Investment Company Act Release No. 17,452 (Apr. 23, 1990) (the "1990 Restricted Securities Release").

[8] In the 1990 Restricted Securities Release, the SEC stated that, in determining the liquidity of a Rule 144A security, the board should consider the unregistered nature of such security as a factor. The SEC also identified certain factors used by funds to determine the liquidity of portfolio securities, including: (1) the frequency of trades and quotes for the security; (2) the number of dealers willing to purchase or sell the security and the number of other potential purchasers; (3) dealer undertakings to make a market in the security; and (4) the nature of the security and the nature of the marketplace trades (e.g., the time needed to dispose of the security, the method of soliciting offers and the mechanics of transfer).

[9] *See* 1990 Restricted Securities Release.

- Municipal lease obligations;
- Interest-only and principal-only fixed-rate mortgage-backed securities issued by the U.S. government or its agencies and instrumentalities;[10]
- Other privately placed or restricted securities; and
- Customized derivative transactions.[11]

Reasons for Regulation

Timely Satisfaction of Redemptions. The SEC's primary stated purpose for regulating fund liquidity is to ensure that funds have adequate liquid assets to satisfy redemption requests within required periods. In the Liquidity Rules Adopting Release, the SEC cited both Section 22(e) of the 1940 Act, which requires an open-end fund to satisfy redemption requests within seven days of receipt, and Rule 15c6-1 under the Securities Exchange Act of 1934, which generally requires broker-dealers to settle transactions in securities no later than the third business day after the trade date (T+3 settlement). Separately, the SEC noted that several funds disclose in their prospectuses that they will satisfy redemption requests within shorter timeframes, e.g., one business day.

ETF Concerns. In the Liquidity Rules Adopting Release, the SEC also specifically noted the importance of maintaining portfolio liquidity in ETFs. With respect to ETFs that satisfy redemption requests in kind, the SEC stated that, while in-kind redemptions relieve the need to sell portfolio assets to satisfy redemptions, using illiquid securities to satisfy redemptions could result in costs to redeeming authorized participants or their clients, which could be reflected in the bid-ask spread for the ETF's shares and ultimately impact investors. The SEC further noted that it may be difficult for an authorized participant or its client to assemble the basket needed to purchase new shares of an ETF with a portfolio heavily weighted toward illiquid securities. In addition, the SEC stated that an illiquid ETF portfolio may frustrate the ability to evaluate arbitrage opportunities because of the difficulties market makers may have in pricing, trading and hedging their exposure to the ETF. Together, these factors could affect the ability of an ETF's shares to trade at or near net asset value.

Industry Developments. In the Proposing Release, the SEC noted that it had not updated its liquidity guidance for funds in over two decades, and that an updated liquidity risk management process is merited in light of developments in the fund industry and SEC staff observations of current liquidity risk management practices. The SEC noted the rapid growth of funds focusing on less liquid strategies, such as fixed-income (including high yield and non-U.S. fixed-income), emerging markets and

10 Investment Company Filing Guidance, SEC No-Action Letter (Dec. 2, 1992).

11 Hon. Edward J. Markey, SEC No-Action Letter (Sept. 26, 1994).

"alternative" strategies, over the last decade and the higher share of industry assets these funds now represent versus funds that use more liquid strategies, e.g., U.S. domestic equity funds. The SEC also noted that funds are increasing investments in assets with longer settlement periods, such as bank loans and loan participations, as well as certain non-U.S. securities, at a time when the industry trend is toward shorter settlement periods for redemptions of fund shares. The SEC stated that this may create a mismatch between the time required to convert fund investments to cash and the time a fund needs cash to satisfy redemption requests. Finally, the SEC noted its concern, based on a two-year observation by the SEC staff of liquidity risk management practices across the fund industry, that liquidity risk management programs vary widely in the industry, and that while some fund complexes have adopted comprehensive procedures for assessing, classifying and managing portfolio liquidity risk, others have processes that are much less robust and may neither take into account different market conditions in evaluating portfolio investment liquidity nor involve independent oversight of liquidity outside the portfolio management function.

Liquidity Risk Management Programs

As stated in the Liquidity Rules Adopting Release, the SEC adopted the Liquidity Rules "to promote effective liquidity risk management throughout the open-end fund industry and thereby reduce the risk that funds will not be able to satisfy redemption or other legal obligations and mitigate potential dilution of the interests of fund shareholders."

New Rule 22e-4 requires each registered open-end fund, including open-end ETFs but excluding money market funds ("Funds"),[12] "to adopt and implement a written liquidity risk management program reasonably designed to assess and manage the fund's liquidity risk." The rule distinguishes between ETFs that satisfy redemptions in kind and publish portfolio holdings on a daily basis ("In-Kind ETFs") and other Funds to which the rule applies, exempting In-Kind ETFs from certain provisions.[13]

Under Rule 22e-4, a Fund's liquidity risk management program must incorporate the following five elements:

1. *Assessment, Management and Review of Fund Liquidity Risk*. Based on a consideration of specified factors, each Fund (including In-Kind ETFs) must assess, manage and review at least annually its liquidity risk (i.e.,

[12] Rule 22e-4 defines the term "fund" to mean an open-end management investment company registered or required to register under the 1940 Act, including a separate series of such an investment company, not including a registered open-end management investment company that is regulated as a money market fund or an In-Kind ETF (as defined below). The section of this article relating to the Liquidity Rules refers to all investment companies to which Rule 22e-4 applies, including In-Kind ETFs, by using the capitalized term "Funds."

[13] In addition, closed-end funds are not subject to Rule 22e-4, and unit investment trusts ("UITs") are subject only to a UIT-specific provision of the rule, which is discussed below.

the risk that the Fund could not meet redemption requests without significantly diluting the interests of remaining investors).

2. *Liquidity Classification of Portfolio Investments*. Each Fund (excluding In-Kind ETFs) must classify its portfolio investments, including derivative transactions, as belonging to one of four liquidity categories based on information obtained after reasonable inquiry and considering relevant market, trading and investment-specific considerations, as well as market depth. The classification of portfolio investments may be based, by default, on asset class. The classification of portfolio investments must be reviewed at least monthly in connection with the preparation of a Fund's periodic reporting on new Form N-PORT.

3. *Highly Liquid Investment Minimum*. Any Fund (excluding In-Kind ETFs) that does not primarily hold investments classified as "highly liquid investments" must establish a minimum percentage of the Fund's net assets that will be invested in highly liquid investments, review this minimum percentage at least annually and take certain actions in the event of a shortfall, including confidentially reporting the shortfall to the SEC if the shortfall extends for more than seven consecutive days.

4. *Illiquid Investments*. No Fund (including In-Kind ETFs) may acquire an investment classified as an "illiquid investment" if, immediately after the acquisition, more than 15 percent of its net assets would be invested in illiquid investments. In addition, if the percentage of a Fund's net assets invested in illiquid investments exceeds 15 percent at any time, the Fund must take certain actions, including confidentially reporting the event to the SEC.

5. *Redemptions In Kind*. Any Fund (including In-Kind ETFs) that engages in, or reserves the right to engage in, redemptions in kind must establish policies and procedures regarding how and when the Fund will redeem in kind.

Assessment, Management and Review of Fund Liquidity Risk

Rule 22e-4 requires that, as part of its liquidity risk management program, each Fund (including In-Kind ETFs) assess, manage and review at least annually its liquidity risk.

Liquidity Risk. Rule 22e-4 defines liquidity risk as "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." The final definition of liquidity risk reflects certain changes from the definition that appeared in the proposed rule.[14] In the Liquidity Rules Adopting Release, the SEC stated that the final definition is intended to clarify that, while there is an inherent connection between liquidity and valuation, the focus of liquidity risk management should be reducing the dilution of shareholder interests rather than strictly protecting shareholder value. The SEC sought to alleviate concerns that investors may conclude that effective liquidity risk management might involve generally protecting shareholders against losses. The SEC stated that the "significant dilution" standard in the final rule, as opposed to a materiality standard that appeared in the proposed rule, was intended to alleviate confusion. The SEC noted that significant dilution does not include slight net asset value movements and is not limited to fire sale situations, but that the focus should be on a Fund's ability to satisfy redemptions in a manner that does not harm investors. In addition, unlike the proposed rule, the final rule does not expressly require Funds to consider levels of expected redemption requests under both normal and stressed conditions. However, under the liquidity risk factors described below, the final rule requires Funds to consider varying market conditions when assessing liquidity risk.

Liquidity Risk Factors. In assessing, managing and reviewing liquidity risk, Rule 22e-4 requires a Fund to consider the following factors, as applicable.

1. Its investment strategy and the liquidity of its portfolio investments during both normal and reasonably foreseeable stressed conditions, including:

    - Whether its investment strategy is appropriate for an open-end fund,

    - The extent to which its investment strategy involves a relatively concentrated portfolio or large positions in particular issuers, and

    - The use of borrowings for investment purposes and derivative transactions;

2. Short-term and long-term cash flow projections during both normal and reasonably foreseeable stressed conditions;

3. Holdings of cash and cash equivalents, as well as borrowing arrangements and other funding sources; and

4. For ETFs only:

    - The relationship between the ETF's portfolio liquidity and the way in which, and the prices and spreads at which, the ETF's shares trade,

[14] As proposed, Rule 22e-4 would have defined liquidity risk as "the risk that the fund could not meet requests to redeem shares issued by the fund that are expected under normal conditions, or are reasonably foreseeable under stressed conditions, without materially affecting the fund's net asset value."

including the efficiency of the arbitrage function and the level of active participation by market participants (including authorized participants), and

- The effect of the composition of baskets on the overall liquidity of the ETF's portfolio.

In the Liquidity Rules Adopting Release, the SEC stated that this list of liquidity risk factors is not intended to be exhaustive, and that Funds must take into consideration other factors to the extent necessary to adequately assess and manage liquidity risk. In addition, the SEC stated that if any of the specified liquidity risk factors does not apply to a particular Fund, that Fund need not consider the factor in assessing, managing and reviewing its liquidity risk. This flexible approach differs from the more rigid approach contained in the proposed rule, which would have required each Fund to consider a specified set of liquidity risk factors. We note that within a fund complex, different liquidity risk factors, including the factors listed above and any others that may be necessary, may apply to different Funds.

Liquidity Classification of Portfolio Investments

Rule 22e-4 requires that, as part of its liquidity risk management program, each Fund (excluding In-Kind ETFs) classify its portfolio investments, including derivative transactions, into the following four categories:

1. *Highly liquid investments*—cash and any investment reasonably expected to be convertible into cash under current market conditions *in three business days or less* without a significant change in market value. These investments represent the most liquid investments in a Fund's portfolio that can be sold and settled within a standard three-business-day (T+3) settlement period without affecting market value.[15]

2. *Moderately liquid investments*—any investment reasonably expected to be convertible into cash under current market conditions *in seven calendar days or less, but in more than three calendar days,* without a significant change in market value.[16] These investments represent the investments in a Fund's portfolio that are less liquid than highly liquid investments but that may be sold and settled within the seven-day period

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15 In the Liquidity Rules Adopting Release, the SEC noted that this category should not be interpreted as suggesting that Funds adopt a practice of meeting redemptions first by selling their highly liquid investments.

16 A note to Rule 22e-4 states that if an investment could be viewed as either a highly liquid investment or a moderately liquid investment because the period to convert the investment to cash depends on the calendar or business day convention used, the investment should be classified as a highly liquid investment.

for satisfying redemption requests mandated by Section 22(e) without affecting market value.

3. *Less liquid investments*—any investment reasonably expected to be able to be sold or disposed of under current market conditions *in seven calendar days or less* without a significant change in market value, *but in which the sale or disposition is reasonably expected to settle in more than seven calendar days*.

4. *Illiquid investments*—any investment reasonably expected *not to be able to be sold or disposed of under current market conditions in seven calendar days or less* without a significant change in market value. This definition is intended to be consistent with the definition of "illiquid securities" under current SEC guidance while incorporating elements of more robust liquidity assessment practices observed in the industry.[17]

In classifying portfolio investments into the categories described above, Rule 22e-4 provides that a Fund must use information obtained after reasonable inquiry and take into account relevant market, trading and investment-specific considerations, as well as market depth. The system for classifying portfolio investments in the final rule represents a significant change from the proposed rule, under which all Funds (including In-Kind ETFs) would have been required to classify their portfolio investments into six different categories based on the number of days required to convert the investment into cash without a significant change in market value. While the final liquidity classification scheme is somewhat simpler and more flexible than the proposed rule, it represents a significant change from current regulatory requirements and industry practices.

Asset Class Categorization. Final Rule 22e-4 permits Funds, as a default, to classify and review portfolio investments, including derivative transactions, by asset class, but provides that a Fund must separately classify and review any portfolio investment within an asset class if the Fund or its investment adviser has information about any market, trading or investment-specific considerations reasonably expected to significantly affect the liquidity characteristics of that portfolio investment as compared to the Fund's other portfolio holdings within the asset class. This represents a significant change from the proposed rule, which did not permit categorization by asset class. In the Liquidity Rules Adopting Release, the SEC stated that asset class

[17] In the Liquidity Rules Adopting Release, the SEC noted that the requirement that Funds classify portfolio investments taking into account relevant market, trading and investment-specific considerations, as well as market depth, may result in certain Funds conducting a more robust assessment of portfolio investment liquidity than at present. As a result, the SEC noted that although the definitions of "illiquid investments" under Rule 22e-4 and "illiquid securities" under current SEC guidance are similar, the more robust review required by Rule 22e-4 may result in certain Funds concluding that greater portions of their portfolio holdings are illiquid.

categorization is intended to reduce the costs that would have been imposed by requiring liquidity classification to be made on a security-by-security basis.

Rule 22e-4 does not define "asset class" for the purpose of liquidity classification, and the SEC did not otherwise establish, as some commenters suggested, a fixed classification scheme that would establish a standard set of asset classes with corresponding liquidity classifications. Accordingly, until industry norms develop or the SEC or staff provides specific interpretive guidance, there may be some differences in practice concerning how individual portfolio investments are grouped into asset classes for the purpose of liquidity classification.

Market Depth. Under Rule 22e-4, in classifying and reviewing the liquidity of portfolio investments or asset classes, as applicable, a Fund must consider "market depth." Specifically, a Fund must determine whether trading varying portions of a position in a particular portfolio investment or asset class in sizes that the Fund would reasonably anticipate trading could reasonably be expected to significantly affect liquidity. If so, the Fund must take into account this determination when classifying the liquidity of the portfolio investment or asset class.

Other Factors to Consider. Although SEC did not incorporate the following factors from the Proposing Release into final Rule 22e-4, the SEC stated in the Liquidity Rules Adopting Release its belief that these factors could be useful and relevant in classifying the liquidity of a portfolio investment:

- The existence of an active market for the asset, including whether the asset is listed on an exchange, as well as the number, diversity and quality of market participants;
- The frequency of trades or quotes for the asset and average daily trading volume of the asset (regardless whether the asset is a security traded on an exchange);
- The volatility of trading prices for the asset;
- Bid-ask spreads for the asset;
- Whether the asset has a relatively standardized and simple structure;
- For fixed-income securities, the maturity date and date of issue;
- Any restrictions on the trading of the asset and limitations on transfers of the asset;
- The size of the Fund's position in the asset relative to the asset's average daily trading volume and, as applicable, the number of units of the asset

outstanding (including the extent to which the timing of disposing of the position could create any impact on market value); and

- The relationship of the asset to other portfolio assets.

Importantly, the SEC noted that these factors are not intended to represent an exclusive list of the factors a Fund should take into consideration in categorizing the liquidity of a portfolio investment or asset class.

Frequency of Review. Rule 22e-4 requires each Fund to review the liquidity classifications of its portfolio investments at least monthly in connection with the preparation of its periodic reporting on new Form N-PORT. Funds must review the classifications of portfolio investments more frequently in the event of changes to relevant market, trading and investment-specific considerations that are reasonably expected to materially affect a Fund's portfolio investment classifications.

No Intended Impact on Valuation. In the Liquidity Rules Adopting Release, the SEC stated that the liquidity classification process is not intended to impact the valuation of a Fund's portfolio investments. The SEC stated that a Fund need not re-value or re-price a portfolio investment for purposes of liquidity classification, nor incorporate general market movements into liquidity classifications or precisely estimate the impact on market price of a conversion to cash, or sale or disposal.

Segregated and Pledged Assets. Rule 22e-4 requires that a Fund identify the percentages of its highly liquid investments that have been segregated to cover, or pledged to satisfy margin requirements in connection with, derivative transactions classified as moderately liquid investments, less liquid investments and illiquid investments.[18] These percentages must also be reported monthly on new Form N-PORT. As discussed below, the calculation of this percentage may be relevant in determining whether a Fund is subject to the Highly Liquid Investment Minimum requirement of Rule 22e-4.[19]

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18 A note to Rule 22e-4 provides that, in calculating these percentages, a Fund that has segregated or pledged highly liquid investments and non-highly liquid investments to cover derivative transactions in the moderately liquid, less liquid or illiquid categories first should apply segregated or pledged highly liquid investments to cover such derivative transactions unless the Fund has specifically segregated non-highly liquid investments to cover such derivative transactions.

19 We note that Rule 22e-4 does not impose a requirement that only highly liquid investments be used to cover derivative transactions, and that the rule does not otherwise affect prior SEC and staff guidance on asset segregation. *See*, *e.g.*, Securities Trading Practices of Registered Investment Companies, Investment Company Act Release No. 10,666 (Apr. 18, 1979); Merrill Lynch Asset Management, L.P., SEC No-Action Letter (July 2, 1999). However, we note that in December 2015, the SEC proposed changes to asset segregation requirements in connection with a broader rule proposal relating to the use of derivatives by investment companies. *See* Use of Derivatives by Registered Investment Companies and Business Development Companies, Investment Company Act Release No. 31,933 (Dec. 11, 2015).

Use of Third-Party Vendors. In the Liquidity Rules Adopting Release, the SEC stated that a Fund may appropriately use data and analysis from third-party vendors to inform or supplement the Fund's consideration of liquidity in order to determine the liquidity categories in which portfolio investments and asset classes belong. The SEC stated that a Fund's investment adviser, or the officer or officer otherwise designated by the board as being responsible for administering the Fund's liquidity risk management program (i.e., the "person(s) designated to administer the program"), should review the quality of any data received from third parties, as well as the particular methodologies used and metrics analyzed by such third parties, to determine whether these data would effectively inform or supplement the Fund's consideration of the liquidity of its portfolio investments.

> Our Take:
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> While the changes to final Rule 22e-4 regarding the classification of portfolio investments alleviate certain concerns raised through industry comments, the final rule will require significant operational and compliance resources to implement. Even firms that have robust systems for monitoring liquidity today will need to make significant systems enhancements to meet the specific requirements of the final rule. Our experience is that firms have varied ways of monitoring liquidity and current methods likely do not include the four-part classification system set forth in the final rule.

Highly Liquid Investment Minimum

Rule 22e-4 provides that, as part of its liquidity risk management program, any Fund (excluding In-Kind ETFs) that does not primarily hold highly liquid investments must:

1. Determine a minimum percentage of net assets that the Fund will invest in highly liquid investments (a "Highly Liquid Investment Minimum");

2. Review at least annually the Highly Liquid Investment Minimum; and

3. Adopt and implement certain policies and procedures for responding to a shortfall of the Highly Liquid Investment Minimum.

The Highly Liquid Investment Minimum requirement in the final rule differs significantly from a comparable provision in the proposed rule. Proposed Rule 22e-4 would have required all Funds (including In-Kind ETFs and Funds that primarily hold highly liquid investments) to establish a minimum percentage of net assets that must be invested in "three-day liquid assets," i.e., cash or other investments that may be converted into cash within three business days without a material change in market value. Under the proposed rule, the level of this minimum, and any change thereto, would have required board approval. In addition, the proposed rule would have prevented any Fund from acquiring assets convertible into cash over periods greater than three business days if, after the acquisition, the Fund would exceed its three-day liquid asset minimum.

Applicability of Requirement. Rule 22e-4 does not include specific parameters for determining whether a Fund "primarily" holds highly liquid investments; however, the SEC provided the following guidance:

- If a Fund were to hold less than 50 percent of its assets in highly liquid investments, the Fund would be unlikely to qualify as primarily holding highly liquid investments; and
- Portfolio investments that have been segregated or pledged to cover derivative transactions classified as moderately liquid investments, less liquid investment or illiquid investments must be excluded from the calculation of the percentage.[20]

In light of this guidance and in the absence of any further elaboration from the SEC or staff, we believe it would be reasonable to conclude that a Fund that holds more than 50 percent of its assets in highly liquid investments that are not segregated or pledged to cover less liquid derivative transactions primarily holds highly liquid investments, meaning that the Fund would not be required to establish a Highly Liquid Investment Minimum or adopt the shortfall policies and procedures described below.

The applicability of the Highly Liquid Investment Minimum must be determined on a Fund-by-Fund basis, meaning that within a fund complex, only a sub-set of Funds will likely be required to establish a Highly Liquid Investment Minimum. Whether a Fund primarily holds highly liquid investments depends on the Fund's actual portfolio holdings, and the liquidity classification of those holdings, from time to time rather than on the Fund's stated investment policies. Accordingly, the applicability of the Highly Liquid Investment Minimum requirement to a Fund may change over time.

Determination of Highly Liquid Investment Minimum. In determining and reviewing a Fund's Highly Liquid Investment Minimum, Rule 22e-4 requires that a Fund consider the liquidity risk factors described above under "—Assessment, Management and Review of Fund Liquidity Risk," as applicable, but that the risk factors relating to investment strategy and cash flow projections may be considered only as they apply during normal conditions, and during stressed conditions only to the extent they are reasonably foreseeable during the period until the next review of the Highly Liquid Investment Minimum (i.e., no more than one year).

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20 In the Liquidity Rules Adopting Release, the SEC stated that highly liquid investments that have been segregated or pledged to cover lower rated derivative transactions may not provide the same level of liquidity risk management flexibility as investments that have not been segregated or pledged.

While a Fund's Highly Liquid Investment Minimum generally will be set by the person(s) designated to administer the program, in consultation with appropriate advisory personnel, and not by the Fund's board, a Fund's Highly Liquid Investment Minimum may not be changed while the Fund's highly liquid investments are below the determined minimum without approval from the Fund's board, including a majority of the board members who are not "interested persons" of the Fund under the 1940 Act ("independent board members").

While the Liquidity Rules Adopting Release did not include numerical guidance on what might constitute a reasonable standard for setting a Fund's Highly Liquid Asset Minimum, the SEC did provide some factors Funds may consider:

- Funds with investment strategies that experience more volatile flows, such as alternative and emerging market debt funds, and Funds that use leverage strategies, involving either borrowings for investment purposes or the use of derivative transactions that need to be covered, would generally need higher Highly Liquid Investment Minimums than Funds with investment strategies that tend to experience less flow volatility and do not involve leverage;

- Funds with concentrated ownership, including new and recently launched Funds, may need to set relatively high Highly Liquid Investment Minimums in light of the higher risk such Funds face of large redemptions relative to Fund assets;

- Funds may consider the factors listed in the Proposing Release for making cash flow projections;[21] and

- Funds may consider using some form of stress testing or take into account specific historical redemption scenarios.

In the Liquidity Rules Adopting Release, the SEC stated that a Fund may take into account the availability of a borrowing arrangement, such as a line of credit or an inter-fund lending facility, when setting its Highly Liquid Investment Minimum. However, the SEC stated that the availability of borrowing should not result in a one-for-one reduction in the Highly Liquid Investment Minimum. The SEC noted that during times of liquidity stress the full committed amount under a line of credit may not be available, either because other Funds in the complex are also making draws or because the lender or lenders may be under stress, and that it is the SEC's view that liquidity risk management is better conducted primarily through portfolio construction. The SEC also noted that the availability of borrowing under an inter-fund lending facility is

[21] The factors set forth in the Proposing Release are as follows: (1) the size, frequency and volatility of historical purchases and redemptions of Fund shares during normal and reasonably foreseeable stressed periods; (2) the Fund's redemption policies; (3) the Fund's shareholder ownership concentration; (4) the Fund's distribution channels; and (5) the degree of certainty associated with the Fund's short-term and long-term cash flow projections.

subject to the requirements of the applicable exemptive relief, which generally requires an inter-fund loan to be in the best interest of both the lending Fund and the borrowing Fund. During times of high liquidity stress, it may not be in the best interest of any Fund in a complex to lend cash under such a facility.

A Fund's Highly Liquid Investment Minimum, if applicable, must be reported on new Form N-PORT. In addition, as discussed below, a Fund must keep certain records in connection with the establishment and review of its Highly Liquid Investment Minimum.

Shortfall Policies and Procedures. A Fund's policies and procedures must address how to respond to a shortfall of the Highly Liquid Investment Minimum. In the event of a shortfall, the policies and procedures must require the person(s) designated to administer the program to report to the Fund's board no later than its next regularly scheduled meeting with a brief explanation of the causes for the shortfall, the extent of the shortfall and any actions taken in response. If the shortfall continues for more than seven consecutive calendar days, the policies and procedures must require the person(s) designated to administer the program to report to the board within one business day thereafter with an explanation of how the Fund plans to restore the Highly Liquid Investment Minimum within a reasonable period of time. In this case, the Fund would also be required to notify the SEC of the shortfall by filing a non-public current report on new Form N-LIQUID, as discussed below.

Illiquid Investments

Limitation on Acquisition. Rule 22e-4 requires that each Fund's (including In-Kind ETFs) liquidity risk management program provide that the Fund may not acquire an illiquid investment if, immediately after the acquisition, more than 15 percent of the Fund's net assets would be invested in illiquid investments. This provision is substantially similar to a provision that appeared in the proposed rule and is consistent with current SEC guidance on investments in illiquid securities.

Maintenance of 15 Percent Limitation. As under current SEC guidance, final Rule 22e-4 does not strictly require that Funds maintain an ongoing 15 percent limit on illiquid investments, meaning a Fund is not technically required to divest itself of illiquid investments if illiquid investments exceed 15 percent of net assets. The SEC expressly rejected adopting a strict 15 percent maintenance requirement. In the Liquidity Rules Adopting Release, the SEC stated that such a provision could require a Fund to sell illiquid investments at a significant discount to stated value, and possibly at fire sale prices, adversely affecting shareholders and negating certain of the benefits of the liquidity risk management program.

However, if illiquid investments exceed 15 percent of a Fund's net assets for any reason, including as a result of the relative appreciation of illiquid investments, the relative depreciation of other investments or a change in the liquidity classification of one or more portfolio investments, Rule 22e-4 requires the person(s) designated to administer the program to report the event to the board within one business day of the occurrence. This report must include an explanation of the extent and causes for the occurrence and how the Fund plans to bring illiquid investments to or below 15 percent of net assets within a reasonable period of time. The Fund must also notify the SEC of the occurrence by filing a non-public current report on new Form N-LIQUID.[22] If illiquid investments continue to represent more than 15 percent of the Fund's net assets 30 days from the occurrence (and each consecutive 30-day period thereafter), the board, including a majority of independent board members, must assess whether the plan to bring the Fund back into compliance with the 15 percent limit continues to be in the best interest of the Fund.

Redemptions In Kind

Rule 22e-4 provides that, as part of its liquidity risk management program, any Fund (including In-Kind ETFs) that engages in, or reserves the right to engage in, redemptions in kind must establish policies and procedures regarding how and when it will engage in redemptions in kind. This aspect of Rule 22e-4 was adopted largely as proposed.

In the Liquidity Rules Adopting Release, the SEC provided the following guidance on what a Fund's in-kind redemption policies and procedures should include:

- The policies and procedures should specify when in-kind redemptions would be used (i.e., whether at all times or only during periods of stress), as well as what events may lead to the use of in-kind redemptions;
- The policies and procedures should specify whether in-kind redemptions would be used only for redemptions above a certain size, and whether different procedures would be used in connection with redemptions by retail investors, who may have more difficulty receiving in-kind redemptions, and institutional investors, that may be more amenable to in-kind redemptions;
- The policies and procedures should identify how in-kind redemptions would be conducted operationally, including whether in-kind redemptions would be satisfied by distributing a pro rata portion of the Fund's portfolio or on a non-pro rata basis, and if in-kind redemptions are not effected pro rata, how the securities used to satisfy an in-kind redemption would be selected in a manner that maintains fairness both to the redeeming shareholder and to continuing shareholders in the Fund; and

[22] As discussed below, a second current report on Form N-LIQUID would have to be filed once illiquid investments return to or fall below 15 percent of the Fund's net assets.

- The policies and procedures may specify how odd-lot transactions are processed and address relevant tax considerations.[23]

Unit Investment Trusts

Proposed Rule 22e-4 would not have applied at all to UITs, and final Rule 22e-4 does not require a UIT to adopt a liquidity risk management program. However, the final rule does include a requirement for the liquidity of a UIT's portfolio investments to be assessed at the time of initial deposit. Under final Rule 22e-4, on or before the date of the initial deposit of portfolio securities into a UIT, the UIT's principal underwriter or depositor must determine that the portion of the illiquid investments that the UIT holds at the date of deposit is consistent with the redeemable nature of the securities issued by the UIT. The principal underwriter or depositor must also maintain a record of that determination for the life of the UIT and for five years thereafter. This provision uses the same definition of illiquid investments as described above.

In the Liquidity Rules Adopting Release, the SEC stated that it expected the initial review of UIT portfolio liquidity to be similar to the process for determining whether a Fund satisfies the 15 percent limit on illiquid investments contained in Rule 22e-4. We believe this review should be conducted using factors similar to those discussed above that apply to Funds. The SEC further stated that it would be unlikely that a UIT's principal underwriter or depositor could determine that the UIT's holdings of illiquid investments is consistent with its issuance of redeemable securities if illiquid investments were to represent more than 15 percent of the UIT's initial investments.

Board Responsibilities

In the Liquidity Rules Adopting Release, the SEC stated that it believes the role of the board under Rule 22e-4 is one of general oversight. The rule expressly provides for board involvement in the approval and oversight of the liquidity risk management program, but the day-to-day administration of the program will be handled by the Fund's investment adviser and/or officers.

Program Approval. A Fund's board, including a majority of independent board members, must initially approve the liquidity risk management program.[24] Unlike the

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23 In addition, funds should be aware that permitting affiliates to effect in-kind redemptions may present conflicts of interest, and that the SEC staff, in a 1999 no-action letter, issued guidance permitting funds to redeem in kind shares held by fund affiliates under specified conditions. *See* Signature Financial Group, Inc., SEC No-Action Letter (Dec. 28, 1999).

24 In the Liquidity Rules Adopting Release, the SEC stated that board members may satisfy their obligations with respect to the initial approval by reviewing summaries of the program prepared by the Fund's investment adviser, officer or officers who administer the program, legal counsel or other persons familiar with the program.

proposed rule, the final rule does not require board approval of changes to the liquidity risk management program.

Designation of Program Administrator. The board, including a majority of independent board members, must also designate either the Fund's investment adviser or one or more Fund officers as the "person(s) designated to administer the program," i.e., the person or persons responsible for administering the liquidity risk management program and the related policies and procedures. In this regard, while the SEC noted that portfolio management provides valuable input into the liquidity risk management process and that portfolio managers may be consulted as necessary or appropriate in administering the liquidity risk management program, they may not be the sole individuals responsible for administering a Fund's liquidity risk management program. The SEC stated that this prohibition was adopted in order to avoid potential conflicts of interest.

Annual Review. The person(s) designated to administer the program must also prepare and provide to the board for review at least annually a written report addressing the operation of the Fund's liquidity risk management program and assessing the adequacy and effectiveness of its implementation. This report would include, if and as applicable, the operation of the Fund's Highly Liquid Investment Minimum and any material changes to the program.

Other Responsibilities. Other requirements for board involvement under Rule 22e-4 are as follows:

- *Highly Liquid Investment Minimum*:
    - While a Fund's Highly Liquid Investment Minimum, if necessary, is typically set by the person(s) designated to administer the program, in the event of a shortfall of the Highly Liquid Investment Minimum, any change in the Fund's Highly Liquid Investment Minimum must be approved by the Fund's board, including a majority of independent board members.
    - The board must receive a report from the person(s) designated to administer the program at the next regularly scheduled meeting that includes a brief explanation of the causes of any shortfall of a Fund's Highly Liquid Investment Minimum, the extent of the shortfall and any actions taken in response.
    - If a Fund experiences a shortfall lasting more than seven consecutive days, the board must receive within one business day a report from the person(s) designated to administer the program with an explanation of how the Fund plans to restore its Highly Liquid Investment Minimum within a reasonable period of time.

- *Illiquid Investments*:
  - If a Fund holds more than 15 percent of its net assets in illiquid investments, the board must receive within one business day a report from the person(s) designated to administer the program that includes an explanation of the extent and causes of the occurrence and how the Fund plans to bring its illiquid investments to or below 15 percent of net assets within a reasonable period of time.
  - If a Fund's illiquid investments remain above 15 percent of net assets 30 days from the occurrence, and each consecutive 30-day period thereafter, the board, including a majority of independent board members, must assess whether the plan presented to it for reducing illiquid investments to or below 15 percent of net assets continues to be in the best interest of the Fund.

Next Steps:

Implementation of the policies and procedures set forth in final Rule 22e-4 will require lead time. Critical next steps include:

- Identifying the person(s) responsible for administering the program, including whether there are qualified internal resources.
- Assembling an internal working group from various business units including legal, compliance, risk management, portfolio management and technology to develop, test and implement the new policies and procedures.
- Assessing the various asset classes represented by the firm's strategies and developing a framework for assessing liquidity by asset class, and identifying exception scenarios that require case-by-case review.
- Determining whether any re-positioning of Fund portfolios will be required to comply with the final rule.
- Communicating with the Fund board(s) regarding any material issues raised by the final rule.

Recordkeeping

Rule 22e-4 sets forth specific recordkeeping requirements relating to the establishment, maintenance and administration of a Fund's liquidity risk management program. A Fund must keep a written copy of the policies and procedures comprising its liquidity risk management program that are currently in effect, or that were in effect within the past five years. A Fund must maintain copies of any materials provided to its board in connection with the approval of the liquidity risk management program and copies of the annual written reports to the board prepared by the person(s) designated to administer the program relating to the operation of, and assessing the adequacy and effectiveness of the implementation of, the liquidity risk management program for at least five years after the end of the fiscal year in which the documents were provided. Finally, if applicable, a Fund must maintain a written record of the policies and procedures relating to how its Highly Liquid Investment Minimum, and any adjustments thereto, were determined, including the assessment of the various factors considered in setting and periodically reviewing the minimum, as well as any documentation provided to the board relating to a shortfall in the Highly Liquid Investment Minimum, for at least five years following the determination of, and each change to, the Highly Liquid Investment Minimum. In the Liquidity Rules Adopting Release, the SEC stated that the recordkeeping requirements are intended to provide the SEC staff with a basis to evaluate a Fund's compliance with Rule 22e-4.

Disclosure/Reporting Requirements

Form N-1A. In connection with the Liquidity Rules, the SEC adopted certain revisions to Form N-1A. The revisions require a Fund to disclose in its statutory prospectus:

- The number of days following receipt of shareholder redemption requests in which the Fund will pay redemption proceeds to redeeming shareholders, and if the number differs by method of payment the typical number of days or estimated range expected to pay redemption proceeds for each such method; and

- The methods the Fund uses to satisfy redemption requests (e.g., sales of portfolio assets, holdings of cash or cash equivalents, lines of credit, inter-fund lending, redemption in kind) and whether those methods are used regularly or only under stressed market conditions.

In a change from the Proposing Release, the SEC did not adopt a requirement that would have required Funds to file agreements relating to lines of credit as exhibits to Form N-1A.

Form N-CEN. The SEC also adopted certain revisions to Form N-CEN, a new form that will require investment companies to report annually certain census-type information to the SEC in a structured data format.[25] The revisions request certain information of Funds regarding lines of credit and inter-fund lending and borrowing, including whether a Fund has such facilities in place, certain details about such facilities if they are in place and the extent to which such facilities were used during the reporting period. In addition, Form N-CEN will require In-Kind ETFs to identify themselves as such.

Form N-PORT. The SEC adopted certain revisions to Form N-PORT, a new form that will require certain investment companies to report monthly portfolio holding information to the SEC in a structured data format.[26] While Funds will be required to file Forms N-PORT on a monthly basis, only the report filed at the end of a Fund's fiscal quarter will be available to the public, 60 days after quarter end. Form N-PORT will require a Fund to report:

- The aggregate percentage of the Fund's portfolio investments that are assets (i.e., excluding any investments that are reflected as liabilities on the balance sheet), compared to total investments that are assets, classified in each of the four liquidity categories specified in Rule 22e-4;
- The percentages of the Fund's highly liquid investments that have been segregated or pledged to cover derivative transactions classified as moderately liquid investments, less liquid investments and illiquid investments;
- The liquidity classification of each portfolio investment listed on the Fund's schedule of portfolio investments; and
- If applicable, the Fund's current Highly Liquid Investment Minimum, the number of days the Fund's holdings of highly liquid investments fell below the Highly Liquid Investment Minimum during the reporting period and any changes in the Fund's Highly Liquid Investment Minimum during the reporting period.

Form N-LIQUID. The SEC adopted new Rule 30b1-10, which will require Funds subject to Rule 22e-4 to file current reports on Form N-LIQUID under certain circumstances. Form N-LIQUID is a confidential filing. Although the form indicates that the SEC does not intend to make public any information reported on the form that identifies a

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[25] *See* Investment Company Reporting Modernization, Investment Company Act Release No. 32,314 (Oct. 13, 2016) (the "Reporting Modernization Release").

[26] *See* Reporting Modernization Release.

particular Fund, the form states that information reported on Form N-LIQUID may be used in enforcement actions.[27]

A current report on Form N-LIQUID must be filed within one business day of the occurrence of one of the following events:

- If more than 15 percent of a Fund's net assets are, or become, illiquid investments, the Fund must file a Form N-LIQUID disclosing the date on which illiquid investments exceeded 15 percent of net assets, the current percentage of net assets represented by illiquid investments, certain identifying information about each illiquid investment held by the Fund and the percentage of the Fund's net assets each such illiquid investment represents.

- If a Fund has filed a Form N-LIQUID pursuant to the preceding paragraph and the illiquid investments in its portfolio decrease to 15 percent or less of net assets, the Fund must file a Form N-LIQUID disclosing the date on which net assets fell to or below 15 percent of net assets and the current percentage of net assets represented by illiquid investments.

- If the percentage of a Fund's net assets represented by highly liquid investments falls below the Fund's Highly Liquid Investment Minimum for more than seven consecutive calendar days, the Fund must file a Form N-LIQUID disclosing the date on which its holdings of highly liquid investments fell below the Highly Liquid Investment Minimum.

Our Take:

The new requirement to report to the SEC when illiquid assets exceed 15 percent of net assets will cause Funds to establish internal monitoring thresholds below the reporting limit. Notwithstanding the confidential nature of the Form N-LIQUID filing, Funds will be highly incentivized to ensure that illiquid assets do not increase to reporting levels.

[27] The Liquidity Rules Adopting Release indicates that the SEC staff expects Form N-LIQUID filings will be fairly rare; based on a review of Form N-CR filings by money market funds between July 2015 and July 2016, the staff estimated that an average of 30 reports would be filed per year in response to each of the three trigger events described above.

VedderPrice

Swing Pricing Rules

Background

Rule 22c-1 under the 1940 Act generally requires open-end fund shares to be priced at the net asset value per share next computed after the receipt of a purchase or redemption request. Purchases or sales of portfolio investments in response to purchase or redemption requests, respectively, can subject a fund to certain costs, including trading costs, as well as changes to the market values of portfolio investments as a result of the fund's purchase or sale activities, that dilute the interests of shareholders. However, these costs are not typically reflected in the net asset value per share at which a purchasing or redeeming shareholder's transaction is priced.

To address this issue in part, the SEC in 2005 adopted Rule 22c-2 under the 1940 Act, which permits funds to impose a fee of up to 2 percent on shareholders' redemptions and requires fund boards to consider whether or not to impose a redemption fee.[28] This rule permitted funds to implement a mechanism whereby redeeming shareholders, including shareholders that redeem their shares shortly after purchase, pay a fee that helps offset the market impact and trading costs their redemption activity imposes on continuing shareholders.

Swing pricing, which is currently used by collective investment trusts in certain non-U.S. jurisdictions, is another method that has been developed to address this issue. Under swing pricing, if net purchase activity on a particular day exceeds a certain threshold, a Fund's net asset value per share for that day is adjusted upward; if net redemption activity on a particular day exceeds a certain threshold, a Fund's net asset value per share for that day is adjusted downward. The adjustments in net asset value per share are intended to mitigate the dilutive effects of purchase or redemption activity on the interests of continuing investors.

Swing Pricing Policies and Procedures

Under Rule 22c-1(a)(3), an open-end fund (other than a money market fund or an ETF) (a "Fund")[29] may, but is not required to, use swing pricing to adjust the net asset value per share at which purchase and redemption transactions are effected to mitigate dilution of the value of its outstanding shares as a result of purchase and redemption

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[28] Mutual Fund Redemption Fees, Investment Company Act Release No. 26,782 (Mar. 11, 2005).

[29] Rule 22c-1(a)(3) defines the term "fund" to mean a registered open-end management investment company, but not a registered open-end management investment company that is regulated as a money market fund or an exchange-traded fund. The section of this article discussing the Swing Pricing Rules refers to such investment companies by using the capitalized term "Funds."

activity, provided the Fund has established and implemented swing pricing policies and procedures in accordance with the rule.[30]

A Fund's swing pricing policies and procedures must require the Fund to adjust its net asset value per share by a single stated percentage of net asset value (i.e., a "Swing Factor") once the level of net purchases into, or net redemptions from, the Fund has exceeded a stated threshold amount (i.e., a "Swing Threshold"). A Fund may establish multiple Swing Thresholds at differing levels of net purchases or net redemptions and have different Swing Factors that are triggered when net purchases or net redemptions exceed these Swing Thresholds. The policies and procedures must also specify the process for determining the Fund's Swing Threshold(s) and Swing Factor(s), in each case based on a consideration of specified factors. Finally, a Fund must establish an upper limit on its Swing Factor(s), which may not exceed 2 percent of net asset value per share.[31]

Operation of Swing Pricing

Rule 22c-1(a)(3) provides that, in determining whether a Fund's level of net purchases or net redemptions has exceeded a Swing Threshold, the Fund's investment adviser, or the Fund officer or officers otherwise designated by the board as being responsible for administering the swing pricing policies and procedures (the "person(s) responsible for administering swing pricing"), may make this determination based on the receipt of sufficient information about the daily purchase and redemption activity by the Fund's investors ("Investor Flow") to allow the Fund to make a reasonable high-confidence estimate of whether it has crossed a Swing Threshold. In making this determination, in-kind purchases or redemptions must be excluded. Investor Flow information may include individual, aggregated or netted orders and may include reasonable estimates where necessary. In addition, for Funds with multiple share classes, the Swing Pricing Adopting Release indicates that the net purchase or net redemption activity of all share classes should be included in the determination of whether a Swing Threshold has been crossed, and that if a Fund with multiple share classes determines in accordance with its swing pricing policies and procedures that net asset value per share should be adjusted, the net asset value per share of each share class must be adjusted.

Estimating Investor Flows. Rule 22c-1(a)(3) provides that a Fund using swing pricing must make a determination based on whether a Swing Threshold has been crossed on

[30] Swing pricing will not be available to money market funds, ETFs, closed-end funds or UITs. In addition, under Rule 22c-1(a)(3), a Fund (a "Feeder Fund") that invests in another Fund (a "Master Fund") pursuant to Section 12(d)(1)(E) of the 1940 Act may not use swing pricing to adjust the Feeder Fund's net asset value per share. However, a Master Fund may use swing pricing to adjust its net asset value per share pursuant to the requirements of Rule 22c-1(a)(3).

[31] In the Swing Pricing Adopting Release, the SEC stated that, given the role swing pricing may play in managing liquidity risk, a Fund's swing pricing policies and procedures may be incorporated into the Fund's Rule 22e-4 liquidity risk management policies and procedures.

reasonable high-confidence estimates of Investor Flows. In the Swing Pricing Adopting Release, the SEC stated that it understands the deadline by which a Fund must calculate its daily net asset value per share may precede the time the Fund or its pricing agent receives final information regarding Investor Flows from the transfer agent. Accordingly, the SEC stated that Funds that use swing pricing would likely need to develop processes and procedures to gather sufficient Investor Flow information from transfer agents to enable them to make reasonable high-confidence estimates. The SEC further stated that it does not believe complete information will be necessary to make such an estimate, and that a Fund may wish to consider establishing policies and procedures to make the necessary estimates based on information that can be received. We believe one of the primary challenges to implementing and operating swing pricing will be determining how to receive sufficient information to make reasonable high-confidence estimates of Investor Flow information in order to avoid errors in the calculation of net asset value per share that require remediation.

Symmetrical Application. Under Rule 22c-1(a)(3), swing pricing applies to adjust net asset value per share by the same amount when either net purchases or net redemptions exceed the applicable Swing Threshold. In the Swing Pricing Adopting Release, the SEC acknowledged that the impacts redemption activity and purchase activity may have on dilution may differ; however, the SEC stated that both purchases and redemptions may cause shareholder dilution under certain circumstances.

Swing Thresholds

Rule 22c-1(a)(3) requires that a Fund's swing pricing policies and procedures specify how the Fund's Swing Threshold(s) are determined, based on the following factors:

1. The size, frequency and volatility of historical net purchases or net redemptions of Fund shares during normal and stressed periods;

2. The Fund's investment strategy and the liquidity of the Fund's portfolio investments;

3. The Fund's holdings of cash and cash equivalents, as well as borrowing arrangements and other funding sources (e.g., lines of credit, inter-fund lending facilities); and

4. The costs associated with transactions in the markets in which the Fund invests.

Each of these factors must be considered in setting a Fund's Swing Threshold(s); however, Funds may adopt additional factors. In the Swing Pricing Adopting Release, the SEC stated that 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 in an amount or of a type that may subject the Fund to material liquidity or transaction costs, and that the four identified factors are intended to help a Fund estimate this threshold.

Multiple Swing Thresholds. Final Rule 22c-1(a)(3) was modified from the proposed rule to permit, but not require, Funds to set multiple Swing Thresholds that trigger progressively greater Swing Factors, subject in each case to a 2 percent upper limit, resulting in greater adjustments to net asset value per share at incrementally higher levels of purchase or redemption activity. In the Swing Pricing Adopting Release, the SEC stated that this feature would allow Funds to more effectively mitigate shareholder dilution because the costs associated with purchase or redemption activity may increase as the levels of such purchase or redemption activity increase.

Swing Factors

Rule 22c-1(a)(3) requires that a Fund's swing pricing policies and procedures specify how the Fund's Swing Factor(s) are determined, based on the following factors:

1. The establishment of an upper limit on the Swing Factor(s) used, which may not exceed 2 percent of net asset value per share; and

2. A determination that the Swing Factor(s) used are reasonable in relation to certain costs.

In determining the Swing Factor(s) and the upper limit, Rule 22c-1(a)(3) permits the person(s) responsible for administering swing pricing to take into account only the near-term costs expected to be incurred by the Fund as a result of net purchases or net redemptions occurring on the day the Swing Factor(s) are used. These costs include: spread costs; brokerage commissions, custody fees and any other charges, fees and taxes in connection with purchases or sales of portfolio investments resulting from the day's net purchases or net redemptions; and borrowing-related costs incurred to satisfy redemption requests.

Upper Limits

Unlike proposed Rule 22c-1(a)(3), the final rule requires that a Fund's swing pricing policies and procedures establish an upper limit for the Fund's Swing Factor, and that this upper limit may not exceed 2 percent of net asset value per share. In the Swing Pricing Adopting Release, the SEC stated that the 2 percent cap was intended to prevent Funds from setting a Swing Factor that could place "an undue restriction or *de facto* gate on shareholders' ability to redeem their shares and to prevent potentially unfair treatment of shareholders and abusive practices." The SEC also noted that Rule 22c-2 under the 1940 Act places an upper limit of 2 percent on redemption fees permitted under that rule, and that Rule 2a-7(c)(2) under the 1940 Act permits money market funds to impose a liquidity fee of no more than 2 percent. The SEC further stated that many Funds may consider 2 percent as a "default" upper limit, but that a Fund, with board approval, may find that a lower limit is in its best interest.

Board Responsibilities

Approval of Policies and Procedures; Other Board Involvement. Rule 22c-1(a)(3) establishes a significant role to be played by the board in connection with a Fund's swing pricing policies and procedures. Under the rule, the board, including a majority of independent board members, must approve a Fund's swing pricing policies and procedures, as well as the Fund's Swing Threshold(s) and the upper limit on the Swing Factor(s) used.[32] Unlike the proposed rule, the final rule does not require the board to approve all material changes to a Fund's swing pricing policies and procedures, nor is the board expressly required to approve any decision to suspend or terminate a Fund's swing pricing policies and procedures.[33] However, the final rule retains the requirement that the board, including a majority of independent board members, approve any changes to the Swing Threshold(s) or upper limit on the Swing Factor(s) used. In the Swing Pricing Adopting Release, the SEC stated that while board review may limit a Fund's ability to immediately or frequently change a Swing Threshold, the SEC was of the view that board review and approval of Swing Thresholds would help ensure that such thresholds are in the best interests of Fund shareholders, and that board involvement would act "as an important check" on the discretion afforded the person(s) responsible for administering swing pricing.

Determinations whether to use swing pricing and, if swing pricing is to be used, the levels at which to set a Fund's Swing Threshold(s), Swing Factor(s) and upper limit should be made on a Fund-by-Fund basis within a fund complex. In the Swing Pricing Adopting Release, the SEC stated that a fund complex may use swing pricing for certain Funds in the complex but not others, and may establish different Swing Threshold(s) for different Funds in the complex.

Designation of Swing Pricing Administrator. Under Rule 22c-1(a)(3), the board, including a majority of independent board members, must also designate the Fund's investment adviser or one or more Fund officers as the "person(s) responsible for administering swing pricing," i.e., the person or persons responsible for administering the swing pricing policies and procedures. Similar to Rule 22e-4's requirement with respect to the administration of liquidity risk management policies and procedures, Rule 22c-1(a)(3) requires that the administration of swing pricing be reasonably

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32 Under Rule 22c-1(a)(3), there is no express finding that must be made by a board in approving swing pricing for a Fund. In addition, unlike Rule 22c-2 relating to redemption fees, there is no requirement that a Fund's board make an express determination regarding whether the use of swing pricing is necessary or appropriate.

33 In the Swing Pricing Adopting Release, the SEC stated that, in light of potential complications arising when Funds using swing pricing merge, the boards of both merging Funds may want to consider whether to temporarily suspend a Fund's swing pricing policies and procedures ahead of the merger. Based on this statement, and in the absence of any other guidance from the SEC, we believe that, notwithstanding the wording of final Rule 22c-1(a)(3), any suspension or termination of a Fund's swing pricing policies and procedures should be made subject to board approval.

segregated from a Fund's portfolio management function and may not include portfolio managers.

Annual Review. Finally, Rule 22c-1(a)(3) requires that the board, including a majority of independent board members, review at least annually a written report prepared by the person(s) responsible for administering swing pricing. This written report must include a review of the adequacy of the Fund's swing pricing policies and procedures and the effectiveness of their implementation, including the impact on mitigating dilution. The report must also describe any material changes to the swing pricing policies and procedures since the date of the last report. In addition, the report must include a review and assessment of the Fund's Swing Threshold(s), Swing Factor(s) and the upper limit on the Fund's Swing Factor(s), in consideration of the applicable factors discussed above, including the information and data supporting the determination of the Swing Threshold(s), Swing Factor(s) and upper limit. The requirement for a formal annual written report was a revision from proposed Rule 22c-1(a)(3), which would have required that a Fund's Swing Threshold be reviewed at least annually. In the Swing Pricing Adopting Release, the SEC stated that Funds may consider adopting swing pricing policies and procedures that require review of Swing Thresholds more frequently than annually or that specify circumstances that would prompt *ad hoc* review of Swing Thresholds.

Our Take:

It is unclear at this stage whether and to what extent Funds will take advantage of the optional swing pricing provisions. This option raises many practical issues that will need to be resolved:

- Will Funds have adequate information regarding Investor Flow information to implement swing pricing within industry standards for publishing daily net asset values?

- Will the operational burdens of implementation outweigh the potential benefits? Will this determination vary by asset class or product type?

- Should Funds disclose swing pricing data including factors and thresholds? Should Funds disclose both swung and unswung net asset values or just a single net asset value? Should Funds disclose whether a net asset value has been swung?

- Will the average retail investor understand the concept?

- Will the Department of Labor’s fiduciary rule have any impact on a decision to implement swing pricing?

Recordkeeping

Rule 22c-1(a)(3) requires that a Fund that uses swing pricing maintain a copy of its swing pricing policies and procedures currently in effect, or in effect at any time within the last six years. The rule also requires that the Fund maintain a copy of each written report provided to the board by the person(s) responsible for administering swing pricing for six years.

In addition, the Swing Pricing Rules include an amendment to Rule 31a-2 under the 1940 Act that requires a Fund that uses swing pricing to preserve for a period of not less than six years from the end of the fiscal year in which any transactions occurred all schedules evidencing and supporting each computation of net asset value of the Fund’s shares, including schedules evidencing and supporting each computation of an adjustment to net asset value per share based on the Fund’s Rule 22c-1(a)(3) swing pricing policies and procedures.

Disclosure Requirements

Form N-1A. The SEC adopted the following changes to Form N-1A in connection with the Swing Pricing Rules:

- If a Fund applies its swing pricing policies and procedures during any of the periods presented in the performance bar chart or the average annual total return table in the summary prospectus, the Fund must include in a footnote to the bar chart or table a general description of the effects of swing pricing on the Fund’s annual total returns (in the bar chart) or average annual total returns (in the table) for the applicable period or periods presented.

- Any Fund that uses swing pricing must include certain swing pricing-related disclosure in its summary prospectus, including an explanation of the Fund’s use of swing pricing. This explanation must include a discussion of what swing pricing is, the circumstances under which swing pricing will be used and the effects of swing pricing on the Fund and its investors, as well as the Swing Pricing upper limit.

- If a Fund (including a fund of funds) invests in other open-end funds, the Fund must state that the Fund’s net asset value is calculated based on the net asset values of the open-end funds in which it invests, and, if applicable, that the prospectuses for those Funds explain the circumstances under which they will use, and the effects of, swing pricing.

- In the financial highlights presentation in the statutory prospectus, a Fund that uses swing pricing must present two calculations of net asset value—Net Asset Value adjusted for GAAP, which would reflect the cumulative effect of swing pricing during the reporting period, and Net Asset Value adjusted pursuant to swing pricing, End of Period, which would reflect the Fund's net asset value per share, as adjusted pursuant to the swing pricing policies and procedures, on the last day of the reporting period. In addition, Funds that use swing pricing must disclose the per-share impact of amounts retained by the Fund during the reporting period relating to swing pricing as a separate line item in the financial highlights.

Regulation S-X. The SEC adopted revisions to Regulation S-X requiring any Fund that adopts swing pricing policies and procedures to disclose in the notes to its financial statements the general methods used to determine whether the Fund's net asset value per share will be adjusted using swing pricing and whether the Fund's net asset value per share has been so adjusted during the year, and include a general description of the effects of swing pricing.

Form N-CEN. The SEC adopted a change to new Form N-CEN, which will require Funds to report whether they engaged in swing pricing during the reporting period, and if so, to disclose the Swing Factor upper limit.

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