CARLTON FIELDS

SEC Adopts Liquidity Risk Programs for Funds

December 22, 2016

On October 13, the SEC adopted rule reforms designed to improve liquidity risk management by open-end funds. **Liquidity Risk Management Programs** Under the reforms, mutual funds (excluding money market funds) and ETFs will be required to implement liquidity risk management programs. Liquidity risk is defined as the risk that a fund could not meet redemption requests without significant dilution of remaining investors' interests in the fund. Under the program, funds will be required to:

- classify each portfolio investment into one of four categories (based on how long it would take to liquidate those investments);
- invest no more than 15 percent of their net assets in illiquid investments;
- set a highly liquid investment minimum; and
- implement procedures to address any shortfall in satisfying that minimum.

The program must be tailored to the characteristics of each fund and will be subject to periodic assessment and board oversight. Also, a fund must confidentially notify the SEC when its illiquid assets exceed 15 percent or its highly liquid assets fall below the fund's minimum. The compliance deadline for the liquidity risk management program requirement is December 1, 2018 for large entities (June 1, 2019 for small entities). **Swing Pricing** The reforms also permit, but do not require, mutual funds (except money market funds and ETFs) to use "swing pricing." A fund using swing pricing would adjust its net asset value (NAV) for days on which it has net purchase or net redemption orders that exceed a specified percentage of the fund's net assets (a "swing threshold"). Swing pricing would allow funds to pass on related portfolio trading costs to purchasing and redeeming shareholders, and protect other shareholders from dilution. For a fund using swing pricing, once the fund's net purchases or redemptions exceed a swing threshold, the fund must adjust its NAV by a swing factor determined according to the fund's policies and procedures. A fund may use investor flow information to reasonably estimate whether it has crossed a swing threshold with high confidence. The swing factor may consider only the near-term costs the fund is expected to incur as a result of the net purchases or redemptions on that day. Funds may not engage in swing pricing until two years after the rule's publication in the Federal Register. **Unique Issues for Variable Insurance Products** The "swing pricing" proposal could uniquely impact underlying funds and issuers of variable insurance products. For example, it may be particularly difficult for unaffiliated underlying funds to reasonably estimate net purchases and redemptions where net purchase and redemption orders are submitted by intermediaries after the close of business each day. Even many non-insurance product funds are skeptical that they will be able to reasonably estimate early enough in the day whether a swing pricing threshold will be exceeded in order to have time to implement swing pricing for that day. In addition, the swing pricing option could present challenges regarding the pricing and costs associated with fund substitutions. Addressing some of these issues may require amendments to fund participation agreements.

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