SEC Proposes Liquidity Risk Programs for Funds

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The SEC proposed rule reforms on September 22 designed to improve liquidity risk management by open end funds.

Liquidity Risk Management Programs

Under the proposed reforms, mutual funds (excluding money market funds) and ETFs would be required to implement liquidity risk management programs. Liquidity risk is defined as the risk of not meeting redemption requests that are expected (or, in times of stress, that are reasonably foreseeable) without materially affecting NAV. Under the program, funds would be required to classify each portfolio investment into one of six categories (based on how long it would take to liquidate those investments) and maintain a three-day liquid asset minimum.

The program must be tailored to the characteristics of each fund and would be subject to periodic assessment and board oversight.

Swing Pricing

The proposed reforms would also permit, but not require, mutual funds (except money market funds and ETFs) to use “swing pricing.” A fund using swing pricing would adjust its NAV for days on which it has large net purchase or net redemption orders. This would allow funds to pass on related portfolio trading costs to purchasing and redeeming shareholders, and protect other shareholders from dilution. Costs that may be reflected in swing pricing include spread costs, brokerage commissions and other transaction fees, change in market price of portfolio assets due to fund trading, and borrowing costs.

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 accurately estimate net purchases and redemptions where they are submitted by a relatively small number of insurers after the close of business each day. In addition, the swing pricing option could present challenges related to the pricing and costs associated with fund substitutions. Addressing some of these issues may require amendments to fund participation agreements.

The comment period for the proposals is open through January 13, 2016.