DEVELOPING A LIQUIDITY RISK MANAGEMENT PROGRAM

Preparing for the SEC's Proposed Rules 22e-4 and 22c-1

In September 2015, the Securities and Exchange Commission (SEC) proposed a rule that would require all registered non-money market open-end funds, including open-end exchange traded funds, to establish a written liquidity risk management program. The proposed new rule 22e-4 outlined that a fund's liquidity risk management program include the following:

1. Classification and ongoing review of the classification of the liquidity of the fund's positions in a portfolio asset;
2. Assessment and periodic review of the fund's liquidity risk; and
3. Management of the fund's liquidity risk, including a requirement to determine a "three-business-day liquid asset minimum."

In addition, the SEC is proposing amendments to rule 22c-1 to permit a fund (except money market funds and exchange-traded funds), under certain circumstances, to use "swing pricing." Swing pricing is the process of adjusting the net asset value of a fund's shares to effectively pass on the costs stemming from shareholder purchase or redemption activity to the shareholders associated with that activity.

As stated in the SEC's Office of Compliance Inspections and Examinations (OCIE) 2016 examination priorities, the SEC will focus on liquidity controls. More specifically, the SEC will examine advisers to funds that have exposure to potentially illiquid fixed income securities, and will review controls over market risk management, valuation, liquidity management, trading activity and regulatory capital.

The proposed new rules have not been finalized. The comment period closed in mid-January 2016, eliciting feedback from the industry on the particulars and intricacies of the proposal, and we now await next steps. While the proposed specifics of the new rules may change, we expect that the spirit will not.

To prepare for the potential adoption of the proposals, keep these key points in mind:

- Prepare for a written liquidity risk management program, which we expect will be required regardless of how prescriptive the final rule is about the program elements.
- Consider the framework for managing liquidity as it relates to your funds. Factors to consider include: assets, liabilities and liquidity management tools, as well as issues that are unique to your firm and funds, such as performance, distribution channels and tenure of the portfolio management team.
- Design your program's framework at a high level. Decide on your approach before you drill down to the specifics – don't try to go anywhere until you know where you're going!
- Assume that some level of asset classification will be required. Consider how you will assess liquidity for types of securities. What logic will you apply? What information will you need to make decisions?
- Consider whether swing pricing is an option for your funds. Are your funds distributed in a channel that makes it a viable option? If so, what will you need to explain to your board so they understand the approach? What does a historical analysis of the daily flows tell you about how to set your swing threshold and factor?

Deliberate thought now about the spirit of the rules, the ultimate objective of market risk mitigation, and a practical approach that is suitable for the funds you manage will lay the foundation and help you to prepare for the issuance of the final new rules.

We will continue to monitor this key issue, and to help our clients navigate the way forward. If you have specific questions about how proposed requirements may affect your fund, please contact us.

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