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Client Alert

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SEC Proposes Changes to Public Liquidity Risk Management Disclosure

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On March 14, 2018, the Securities and Exchange Commission (SEC) proposed amendments to its liquidity management rules (Liquidity Rules). The proposed changes (Proposed Rules) would modify the public liquidity-related disclosure requirements for certain open-end investment management companies. If adopted, the Proposed Rules would:

(1) Eliminate a pending requirement that funds publicly provide the aggregate liquidity classification profile of their portfolios on Form N-PORT on a quarterly basis.

(2) Amend Form N-1A to require funds to discuss in their annual reports the operation and effectiveness of their liquidity risk management programs.

(3) Allow funds to report a single portfolio holding in multiple classification categories on Form N-PORT.

(4) Require funds to report holdings of cash and cash equivalents on Form N-PORT.

The SEC adopted the Liquidity Rules in October 2016 in an effort to promote effective liquidity risk management programs in the fund industry. Since adoption, the SEC has engaged in outreach to identify potential issues associated with the implementation of the Liquidity Rules. In response to certain findings, the SEC postponed the compliance dates for certain provisions of the Liquidity Rules in February 2018 and now has issued these Proposed Rules. The key features of the Proposed Rules are summarized below. For a more in-depth description of the Liquidity Rules, please click here.

Amendment to Public Disclosures on Form N-PORT/Narrative Discussion of Liquidity Management Program in Annual Report

The Proposed Rules seek to replace the requirement for funds to publicly disclose their aggregate liquidity profile on a quarterly basis on Form N-PORT with a new requirement to discuss the operation and effectiveness of a fund's liquidity risk management program in the fund's annual report to shareholders. It is important to note that funds will still be required to classify portfolio holdings into liquidity classification categories, and reprt such classifications along with the highly liquid investment minimum information to the SEC on a non-public basis.

The SEC identified several investor protection concerns with the public disclosure of a fund's aggregate liquidity profile on Form N-PORT. The SEC acknowledged that the liquidity classification of a fund's portfolio is a subjective process and that different managers classifying the same investment may come to different classification conclusions.

Form N-PORT currently requires funds to publicly disclose their aggregate liquidity classifications in a standard format. According to the SEC, this standardized presentation could inaccurately imply to investors that the classifications for all funds were formed through a uniform process and that the resulting classifications would be comparable across funds. The SEC also acknowledged that the information required by N-PORT lacks context and does not provide funds the opportunity to explain to investors the underlying assumptions and methodologies for their classifications.

Finally, the SEC acknowledged that the information publicly disclosed on Form N-PORT singles out liquidity risk, and that focusing on liquidity risk in isolation may encourage investors to pay less attention to other risks that may be more important to their long-term investment goals.

As a result of these concerns, the SEC believes that effective public disclosure of liquidity risks may be better achieved through a narrative discussion in the annual shareholder report, rather than in Form N-PORT. The Proposed Rules would amend Form N-1A to require a fund to include a narrative discussion of the operation and effectiveness of its liquidity risk management program in the "management discussion of fund performance" section of its annual report.

The Proposed Rules release offers guidance on the type of information that funds should consider in the narrative. The narrative should provide information about the operation and effectiveness of the program, and give insight into how the program functioned over the past year. The discussion should provide investors with enough detail to appreciate the manner in which a fund manages its liquidity risk. For example, a fund might opt to discuss the particular liquidity risks that it faced over the past year, such as significant redemptions, changes in the overall market liquidity of the investments the fund holds, or other liquidity risks, and explain how those risks were managed and addressed, and whether those risks affected fund performance. ***Importantly, the new disclosure would not require a fund to disclose any***

specific classification information, although a fund could do so if it wished. The Proposed Rules would not require a fund to disclose publicly the level of its highly liquid investment minimums or any breaches of the 15 percent illiquid investment limit. The Proposed Rules also would re-designate reporting about the percentage of a fund's highly liquid investments that are segregated to cover, or pledged to satisfy, margin requirements to the non-public portion of Form N-PORT.

Single Portfolio Holding in Multiple Classification Categories

The Proposed Rules would allow a fund to report a single portfolio holding in multiple classification categories (or buckets) under certain defined circumstances. The SEC identified three circumstances in which it would be appropriate to classify a single holding into multiple buckets:

1. When a fund determines that classifying a holding into one category would pose difficulties and may not accurately reflect the liquidity of that holding. The SEC offered up the example of a fund holding an asset that includes a put option on a percentage (but not all) of the fund's holding of the asset

2. When sub-advisers managing different portions or "sleeves" of a multi-manager fund's portfolio have differing views of the liquidity classification of a single holding that may be held in multiple sleeves.

3. When funds, for internal risk management purposes, classify their holdings proportionally across buckets, based on an assumed sale of the entire position.

The third circumstance gives funds the option to use a position size bucketing approach (analyzing the entirety of a fund's position and splitting it among buckets), rather than bucketing the entire holding into a single category based on the sizes they reasonably anticipate trading.

Requirement to Report Cash Holdings

The Proposed Rules would require funds to report holdings of cash and cash equivalents on Form N-PORT to allow the SEC to monitor trends in the use of cash and cash equivalents, and more accurately assess the composition of a fund's highly liquid investment minimum. In the Proposed Rule release, the SEC notes that cash held by a fund is a highly liquid investment and would have been included in the aggregate liquidity profile disclosure on Form N-PORT that the Proposed Rules would eliminate. The Proposed Rules would amend Form N-PORT to require registrants to report cash and cash equivalents non-publicly on a monthly basis and publicly on a quarterly basis with a 60-day delay.

Compliance Dates and Request for Comments

If the Proposed Rules are adopted, the compliance dates for the amendments to Forms N-PORT and N-1A will align with the revised compliance dates that the SEC announced in its February 2018 press release: June 1, 2019, for larger funds and December 1, 2019, for smaller funds.

The SEC has requested comments on each of the Proposed Rules and the release includes several specific questions for the industry related to each of the proposals. The comment period ends on May 18, 2018.

Click here for the full rule release.

Commentary

The elimination of the N-PORT requirement to publicly disclose the liquidity bucket and the highly liquid investment minimum information will be welcomed by funds and their service providers; however, funds will still be required under the Proposed Rules to file this information monthly with the SEC on a non-public basis. Accordingly, funds and their service providers will still need to have the same liquidity risk management program in place that was required under the original Liquidity Rules. We do not believe that fund board and service provider responsibilities with respect to liquidity risk management programs will be materially affected by these Proposed Rules.

Investment Management Group

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