SEC Proposes Mutual Fund Rules Related to Liquidity Risk Management

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In its September 22, 2015 open meeting, the Securities and Exchange Commission (SEC) elected to proceed with a rule proposal that, if adopted as proposed, would require mutual funds (open end funds and ETFs, but not money market funds) to establish and operate a board-approved liquidity risk program. These liquidity risk programs will impact many of the participants in mutual fund operations, including fund boards, officers of the fund, portfolio managers, fund accounting and administration, custody, pricing services, transfer agents, and distributors/distribution partners. Two elements of liquidity risk programs, shareholder concentration analysis and swing pricing, will potentially impact mutual fund transfer agents and intermediaries that sell mutual funds to the public. These impacts may require mutual funds to develop new processes, procedures and intermediary agreements to obtain the information needed to comply with these proposed rules.

SHAREHOLDER CONCENTRATION

Among the requirements of liquidity risk programs would be an obligation for each fund to assess its liquidity risk based on a number of prescribed factors, including short- and long-term cash projections taking into account shareholder ownership concentration and the fund's distribution channels, among other things. This analysis would enable mutual funds to understand the degree of risk associated with large shareholders liquidating their holdings in the fund, or intermediaries holding significant assets of the fund (such as in a wrap program) rebalancing their programs or deciding to eliminate the fund from their customers' investment options.

In order to conduct such an assessment of liquidity risks posed by shareholder concentration, mutual funds may need to obtain information from their transfer agents. In some cases, mutual funds may also need to either obtain information about intermediary holdings either through the transfer agent or directly from the intermediaries themselves. The specific requirements for, and frequency of, such information collection will probably not be proscribed in a final rule, but instead would up to each mutual fund to determine.

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SWING PRICING

As a part of this rule proposal, mutual funds would be permitted to voluntarily adopt swing pricing policies. When a mutual fund experiences large inflows of money due to shareholder purchases, or large outflows of money due to shareholder redemptions, the fund may experience additional portfolio trading costs associated with investing or liquidating assets in the fund's portfolio. Swing pricing is a mechanism that is intended to have the purchasing or redeeming shareholder bear the burden of these additional costs, rather than having these dilute the value of the shares owned by underlying shareholders.

As proposed by the SEC, mutual funds may, as part of their liquidity risk programs, monitor shareholder activity throughout each day to determine if the net activity (net purchases or net redemptions) exceed predetermined thresholds set by the fund's board. Because actual net shareholder activity is not usually known until after the net asset value (NAV) is calculated, the fund may have to monitor estimates of net shareholder activity for purposes of determining if the swing threshold is met. If the swing threshold is exceeded, then the fund would adjust its NAV using a predetermined "swing factor". A swing factor is the amount, expressed as a percentage of the fund's net asset value and determined pursuant to the fund's swing pricing procedures, by which a fund adjusts its net asset value. The rule would also require new recordkeeping requirements, including information used to determine the net shareholder activity that triggered a swing pricing event.

Perhaps the most significant issue for transfer agents and intermediaries is how estimates of shareholder activity might be provided to the fund before the fund calculates its NAV. While shareholder activity processed directly by the transfer agency may be able to be estimated, it is unclear how such information could be provided by intermediaries, either directly to the fund or through the fund's transfer agent. Indeed, in many cases, intermediaries do not have information about net purchases or net redemptions for any given mutual fund until hours after the NAV has been published.

The issue of how intermediaries will be able to furnish mutual funds with estimated net shareholder activity is particularly acute, given the trend of an increased percentage of shareholder accounts held in omnibus account arrangements (see "It's Not Your Parent's Transfer Agency: Responding to Changing Dynamics within the Mutual Funds Industry" in the October 2015, STA Newsletter). It remains to be seen whether it is even feasible for intermediaries to develop the capability to provide net purchase/redemption activity to mutual funds by the time a decision to invoke swing pricing must be made.

By proposing this rule, the SEC appears to have prioritized liquidity risk management for open end mutual funds and exchange traded funds. As part of the proposed requirements, the SEC is considering allowing mutual funds to adopt swing pricing on a voluntary basis under certain circumstances. Given the degree to which mutual fund shareholder records are held by omnibus recordkeepers in today's environment, there arises a significant issue for mutual funds that want to adopt swing pricing policies: how will mutual funds be able to obtain estimated net shareholder activity? If the SEC adopts this rule as proposed, the resolution of this question by mutual funds, transfer agents, and intermediaries may well be the single most important issue the industry faces in responding to the rule from a shareholder recordkeeping perspective. The comment period for this rule proposal expires on January 13, 2016, so it will be some time before it becomes clear what action the SEC will take. If swing pricing on a voluntary basis is enacted by the SEC in a final rule, then mutual funds, their intermediaries, and their transfer agents should have sufficient time to work out the logistical issues that the industry would face.

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