Summary of New SEC Requirements for Open-End Fund Liquidity Risk Management

Summary:

On October 13, 2016, the U.S. Securities and Exchange Commission (Commission) unanimously adopted regulatory changes that require open-end funds, including traditional mutual funds and exchange-traded funds, to establish liquidity risk management programs. This *Alert* summarizes in detail the critical elements of this regulatory development.

On October 13, 2016, the U.S. Securities and Exchange Commission (Commission) unanimously adopted new Rule 22e-4 (Liquidity Rule) under the Investment Company Act of 1940 (the 1940 Act) and other regulatory changes that require each open-end fund, including traditional mutual funds and exchange-traded funds (ETFs) but excluding money market funds (MMFs), to establish a formal liquidity risk management program that must include certain key components.[1]

Structure of this Alert

This *Alert* summarizes the critical elements of the Liquidity Rule, as well as related guidance and commentary from the Commission set forth in the Liquidity Program Release, and is structured as follows:

- Section 1 addresses the key components of a liquidity risk management program (Liquidity Program) under the Liquidity Rule, including key responsibilities and duties of a fund's board of directors or trustees;
- Section 2 summarizes new reporting and disclosure responsibilities stemming from the adoption of the Liquidity Rule; and
- Section 3 sets forth the applicable compliance dates for the various regulatory changes associated with the Liquidity Rule.

The primary focus of this *Alert* is to give the reader an understanding of the various elements of the Liquidity Rule, as formally adopted by the Commission. Although this *Alert* does not endeavor to summarize *every* area where the final Liquidity Rule has changed from the Commission's initial proposal on September 22, 2015 (Proposal)[2], this *Alert* does include brief summaries of critical changes from the Proposal that help explain the requirements of the final Liquidity Rule and the related guidance and commentary in the Liquidity Program Release.

---

[1] *See* Investment Company Liquidity Risk Management Programs, Investment Company Act Release No. 32315 (Oct. 13, 2016) (the Liquidity Program Release).

[2] For additional background on the Proposal, *see* Open-End Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release, Investment Company Act Release No. 31835 (Sept. 22, 2015) (the Proposing Release).

Preliminary Note on Application to Different Types of Funds

As a general matter, the Liquidity Rule applies to all open-end funds, other than MMFs. There are, however, certain tailored requirements for ETFs that are designed to recognize and account for ETFs' unique liquidity-related risks. Specifically, the requirements to (i) assign a fund's investments to different liquidity classifications and (ii) determine a minimum amount of a fund's assets that must be invested in "highly liquid" investments, each as discussed in Section 1 of this *Alert*, do not apply to ETFs that qualify as so-called "In-Kind ETFs".[3] In addition, an ETF (including, but not limited to, an In-Kind ETF) must consider certain specified factors, as described in Section 1 of this *Alert*, in connection with assessing, managing and reviewing its liquidity risk. Note also that closed-end funds are excluded from the requirements of the Liquidity Rule, and unit investment trusts (UITs) are subject to the Liquidity Rule only to a limited degree.[4]

Terminology in this *Alert*. Unless otherwise specified, references to a "fund" or an "open-end fund" in this *Alert* encompass *all* open-end funds, including all ETFs[5] but excluding MMFs.

Section 1: Liquidity Risk Management

The Liquidity Rule requires each open-end fund to adopt and implement a formal Liquidity Program. As part of its Liquidity Program, a fund is required to:

- assess, manage and review the fund's "liquidity risk" (as defined below);
- classify the liquidity of the fund's portfolio investments into one of four liquidity classifications (sometimes referred to herein as "buckets" or "categories");
- determine a minimum amount of the fund's net assets that must be invested in "highly liquid investments" that are assets[6] (such minimum is referred to as the fund's "HLIM"); and
- limit the fund's investments in "illiquid investments that are assets" to no more than 15% of the fund's net assets.

In addition, the Liquidity Program Release includes:

- a new requirement for a fund that meets, or reserves the right to meet, shareholder redemptions in-kind to adopt and implement written policies and procedures regarding in-kind redemptions[7];
- guidance on cross trade transactions, particularly in the context of cross trades involving less liquid assets;

[3] *See* Rule 22e-4(a)(9), defining an "In-Kind ETF" as "an ETF that meets redemptions through in-kind transfers of securities, positions, and assets other than a de minimis amount of cash and that publishes its portfolio holdings daily."

[4] Under Rule 22e-4(c), a UIT's principal underwriter or depositor must determine, on or before the initial deposit of portfolio securities into the UIT, that the portion of the illiquid investments the UIT holds or will hold at the date of deposit that are assets is consistent with the redeemable nature of the securities it issues. A UIT must also meet certain recordkeeping requirements.

[5] Exchange-traded managed funds are included within all references to ETFs in this *Alert*.

[6] See footnote 27 below for a description of the significance of the use of the phrase "that are assets" in the context of the Liquidity Rule.

[7] *See* Rule 22e-4(b)(v).

- recordkeeping requirements with respect to a fund's Liquidity Program[8]; and
- certain requirements, as well as the Commission's views, regarding the role of a fund's board, including the board's responsibilities to initially approve the fund's Liquidity Program and appoint person(s) to administer the Liquidity Program.

Assessment, Management and Review of a Fund's Liquidity Risk

The Liquidity Rule requires each fund to assess, manage and periodically review its "liquidity risk," in light of certain specified factors.[9]

Definition of Liquidity Risk. "Liquidity risk" is defined as "the risk that [a] fund could not meet requests to redeem shares issued by the fund without significant dilution of remaining investors' interests in the fund."[10] Although this definition of "liquidity risk" is similar to the definition from the Proposal, under the Proposal, a fund would have been required to assess whether it could meet redemption requests *without materially affecting its NAV*. Recognizing the challenges associated with accurately identifying and measuring the effects of a fund's transaction activity on the fund's NAV, the Commission replaced the proposed NAV-impact standard with a standard focusing on the level of dilution that would harm the interests of remaining fund shareholders, which the Commission believes more directly corresponds to the policy concerns underlying the adoption of the Liquidity Rule.[11]

Liquidity Risk Factors. The Liquidity Rule requires that a fund consider a non-exhaustive list of factors in assessing and managing its liquidity risk (Liquidity Risk Factors).[12] In particular, a fund is required to take into account the following factors, as applicable:

- the fund's investment strategy and liquidity of portfolio investments during both normal and reasonably foreseeable stressed conditions (Investment Strategy Factor);
- the fund's short- and long-term cash flow projections during both normal and reasonably foreseeable stressed conditions (Cash Flow Factor); and
- the fund's holdings of cash and cash equivalents, as well as borrowing arrangements and other funding sources.

In addition, the Liquidity Rule includes the following two additional factors that an ETF must consider, as applicable, which reflect potential liquidity-related concerns that could arise from the unique structure and operation of ETFs[13]:

---

8 *See* Rule 22e-4(b)(3).

9 *See* Rule 22e-4(b)(1)(i).

10 *See* Rule 22e-4(a)(11).

11 Despite this change to the definition of "liquidity risk," the Liquidity Program Release noted that the Commission believes "impacts on valuation may play a significant role in evaluating [a fund's] ability to effectively meet shareholder redemptions while lessening the effects of dilution." With respect to the assessment of whether meeting redemption requests would result in significant dilution of remaining investors' interests, the Liquidity Program Release also indicates that "a fund should consider the impact of liquidity risk on the total net assets of the fund and the adverse consequences such dilution will have on all the fund's remaining shareholders."

12 *See* Rule 22e-4(b)(1)(i)(A) through (C).

- the relationship between the ETF's portfolio liquidity and the way in which, and the prices and spreads at which, ETF shares trade, including, the efficiency of the arbitrage function and the level of active participation by market participants (including authorized participants); and
- the effect of the composition of baskets on the overall liquidity of the ETF's portfolio.

The Commission clarified in the Liquidity Program Release that, to the extent any Liquidity Risk Factor is not applicable to a particular fund, that fund will not be required to consider such Liquidity Risk Factor in assessing and managing its liquidity risk. Moreover, the Liquidity Program Release provides that the list of Liquidity Risk Factors is not meant to be exhaustive and a fund may take into account other considerations (*e.g.*, stress testing results), and indeed must do so to the extent necessary to adequately assess and manage the fund's liquidity risk.

The Liquidity Risk Factors have been modified from the Proposal to reflect additional considerations that the Commission believes could entail heightened liquidity risk and also to condense the proposed factors. Notably, the Commission modified the proposed Investment Strategy Factor to clarify that consideration of a fund's investment strategy must include an evaluation of whether its investment strategy (i) is appropriate for an open-end fund and (ii) involves a relatively concentrated portfolio or large positions in particular issuers.[14] The Investment Strategy Factor also incorporates the requirement to consider the use of borrowings for investment purposes and derivatives. In addition, under the Proposal, the Cash Flow Factor would have codified five separate considerations in evaluating cash flow projections, but the final version of the Liquidity Rule does not enumerate these considerations; instead, they are set forth in the Liquidity Program Release as guidance that the fund may (but is not required) to consider as part of its assessment of the Cash Flow Factor.[15]

<u>Periodic Review of Liquidity Risk</u>. In addition to a fund's obligation to initially assess and manage its liquidity risk, the Liquidity Rule imposes a requirement on each fund to periodically review its liquidity risk. Although the Proposal would not have mandated a minimum frequency for a fund's periodic review, the Liquidity Rule, as adopted, requires a fund to review its liquidity risk no less frequently than annually. In conducting its periodic review, a fund is required to take into account the same Liquidity Risk Factors that it must consider, as applicable, as part of its initial assessment and management of liquidity risk.

Classifying the Liquidity of a Fund's Portfolio Investments

The Liquidity Rule requires each fund, other than In-Kind ETFs, to classify the liquidity of its portfolio investments into one of four liquidity categories.[16]

---

[13] *See* Rule 22e-4(b)(1)(D)(i) through (ii).

[14] As discussed in the Liquidity Program Release, the Commission believes that a specific requirement to consider whether a fund's investment strategy is appropriate for the open-end structure "would supplement existing practices and provide an important additional layer of shareholder protection."

[15] These cash flow considerations include: (i) the size, frequency and volatility of historical purchases and redemptions of fund shares during normal and reasonably foreseeable stressed periods; (ii) the fund's redemption policies; (iii) the fund's shareholder ownership concentration, (iv) the fund's distribution channels; and (v) the degree of certainty associated with the fund's short- and long-term cash flow projections.

[16] *See* Rule 22e-4(b)(1)(ii).

In a significant departure from the Proposal, the Commission adopted a more simplified and consolidated version of the proposed classification scheme, with fewer classification categories (reduced from six to four) based on shorter time projections (reduced from a maximum of 30 days to seven days) and by permitting funds generally to classify portfolio investments by asset class as opposed to on an individual investment-by-investment basis.

Liquidity Classification Categories. The Liquidity Rule requires a fund to classify the liquidity of each of its portfolio investments based on the number of days within which the fund reasonably expects an investment would be convertible to cash (or, in the case of the "less liquid" and "illiquid" buckets, sold or disposed of) in current market conditions without significantly changing the market value of the investment. Specifically, a fund is required to classify each of its portfolio investments into one of the following liquidity buckets[17]:

Highly liquid investments	**Moderately liquid investments**	**Less liquid investments**	**Illiquid investments**
Cash and any investment reasonably expected to be convertible to cash[18] in current market conditions in ***three business days or less*** without the conversion to cash significantly changing the market value of the investment.	Any investment reasonably expected to be convertible to cash in current market conditions in ***more than three calendar days but in seven calendar days or less*** without the conversion to cash significantly changing the market value of the investment.	Any investment reasonably expected to be sold or disposed of in current market conditions in ***seven calendar days or less*** without the sale or disposition significantly changing the market value of the investment, but where the sale or disposition is reasonably ***expected to settle in more than seven calendar days***.	Any investment that may not reasonably be expected to be sold or disposed of in current market conditions ***in seven calendar days or less*** without the sale or disposition significantly changing the market value of the investment.

A fund's determination in classifying its portfolio investments must be based on information obtained after a "reasonable inquiry." In making this determination, a fund is required to take into account:

- relevant market, trading and investment-specific considerations; and
- whether varying portions of a position in a particular portfolio investment (*i.e.*, "market depth"), in sizes that the fund would reasonably anticipate trading, is reasonably expected to significantly affect the liquidity characteristics of that investment.

As adopted, the Liquidity Rule does not include enumerated factors that a fund must evaluate in taking into account relevant market, trading and investment-specific considerations. Rather, the Commission established a "principles-based approach." In contrast, under the Proposal, a fund would have been required to specifically consider nine separate factors, to the extent applicable, in classifying the liquidity of each portfolio position in a particular asset.[19] The Commission determined not to codify these proposed factors in the final version of the

17 Although the timeframes referenced in the "moderately liquid," "less liquid" and "illiquid" buckets are tied to the statutorily required seven *calendar*-day-period in which funds are required to pay redeeming shareholders (*see* Section 22(e) of the 1940 Act), the "highly liquid" classification category references *business* days because, in the Commission's view, a calendar day standard for short time periods could be unworkable if the time period covers weekends or holidays, during which trading will not occur.

18 Under Rule 22e-4(a)(3), "convertible to cash" means "the ability to be sold, with the sale settled."

19 The nine factors set forth in the Proposing Release (and also included in the Liquidity Program Release as part of the "principles-based approach") are: (1) existence of an active market for the asset, including whether the asset is listed on an exchange, as well

Liquidity Rule in recognition that certain factors would be more informative to some funds than others, depending on the fund's investment strategy and liquidity risk profile, and because the Commission was concerned that codifying the factors could result in a fund taking a less customized approach. Although the proposed factors are not required to be considered in making a liquidity classification determination, the Commission indicated that they could be useful and relevant as aspects of the general market, trading and investment-specific considerations that a fund must take into account under the Liquidity Rule. In addition, the Commission observed that a fund could, but is not required to, use data and analyses provided by third-party vendors to inform or supplement the fund's own consideration of the liquidity classification of an asset class or investment.

To the extent a fund determines that the market depth for an investment is reasonably expected to significantly affect its liquidity, the fund would need to take this into account in classifying the liquidity of that investment. The Liquidity Rule, as adopted, does not appear to permit different classifications for portions of a particular investment, which would have been mandated under the Proposal. Instead, a fund must determine whether transactions involving portions of a particular investment, in sizes that the fund would reasonably anticipate trading, are reasonably expected to significantly affect the liquidity characteristics of that investment. If so, a fund must take this determination with respect to the anticipated trading levels into account when classifying the liquidity of the entire investment. Thus, in the Commission's view, if a fund that anticipates trading only small- or moderately-sized blocks of a position determined that, after conducting the required market depth analysis, a particular investment should be classified in a less liquid category (*e.g.*, due to a sudden decrease in market depth as a result of a major market participant exiting the market), the new liquidity classification that the fund assigns to this investment *would apply to the entirety of the fund's position in that investment (not, as proposed, to portions of that position).*

Illiquid Investments. In a departure from the Proposal, the Commission incorporated an "illiquid investment" classification into the broader classification scheme (*i.e.*, the four categories listed in the above chart). By harmonizing the limitations on a fund's illiquid investments (described below under "*15% Limit on Illiquid Investments*") with the general liquidity classification framework, the Commission sought to create consistency in the value impact[20] standards used across the liquidity categories, which otherwise would have been different under the Proposal. In addition, as part of this harmonization, the Commission withdrew its existing

as the number, diversity and quality of market participants; (2) frequency of trades or quotes for the asset and average daily trading volume of the asset (regardless of whether the asset is a security traded on an exchange); (3) volatility of trading prices for the asset; (4) bid-ask spreads for the asset; (5) whether the asset has a relatively standardized and simple structure; (6) for fixed income securities, maturity and date of issue; (7) restrictions on trading of the asset and limitations on transfer of the asset; (8) the size of the fund's position in the asset relative to the asset's average daily trading volume and, as applicable, the number of units of the asset outstanding; and (9) relationship of the asset to another portfolio asset.

[20] The value impact standard incorporated into the liquidity classification requirement concerns the time period in which conversion to cash (or in some cases, sale or disposition) of an investment is reasonably expected to occur in current market conditions without "significantly changing the market value of the investment." This departure from the value impact standard under the Proposal – convertible to cash "at a price that does not materially affect the value of that investment immediately prior to sale" – highlights that the final standard does not require a fund to actually re-value or re-price the investment for classification purposes, nor does the final standard require the fund to incorporate general market movements in liquidity determinations or estimate market impact to a precise degree.

Commission guidance[21] with respect to illiquid assets and replaced it with new regulatory requirements, as further described below.

Classification Based on Asset Class. In an important change from the Proposal, the Liquidity Rule, as adopted, generally permits a fund to, as a starting point, classify the liquidity of its portfolio investments according to their asset class.[22] This approach recognizes that many investments within an asset class may be considered interchangeable from a liquidity perspective and it will have the effect of lessening operational burdens associated with the classification requirement.[23]

Importantly, however, this general rule will not apply, and a fund will be required to separately classify any individual investment, if the fund, after reasonably inquiry, has information about any market, trading, or investment-specific considerations that are reasonably expected to significantly affect the liquidity characteristics of that investment as compared to the fund's other portfolio holdings within that class (Exception Processes). For instance, a fund could determine that high credit quality corporate bonds generally fall into a particular liquidity bucket, but, if the fund has information that certain bonds' bid-ask spreads are significantly wider or more volatile than those of their peers, the fund would be required to separately assess these bonds and potentially classify them into a less-liquid category than the fund's other holdings within the same asset class. The Liquidity Rule does not specify precisely how a fund must identify investments that should be classified separately as part of its Exception Processes, although the Commission suggested that reasonably designed procedures likely would include specifying the sources of inputs that inform its Exception Processes and particular variables that could affect the fund's classification of certain investments.[24]

Classification Issues Arising With Respect to Derivatives. The liquidity classification requirements cover each of a fund's investments, including the fund's positions in derivatives. As an additional requirement relating specifically to derivatives, the Liquidity Rule requires a fund that has classified derivatives as "moderately liquid," "less liquid" or "illiquid" to identify and disclose the percentage of the fund's "highly liquid" investments that have been segregated to cover, or pledged to satisfy margin requirements in connection with, derivatives in each of these classification categories.[25] The Commission believes this requirement will permit investors to better understand the percentage of a fund's highly liquid investments that is composed of "encumbered assets" that may not be immediately available for liquidity risk management purposes.

---

[21] *See* Changes to Method of Determining Holding Period of Restricted Securities Under Rules 144 and 145, Investment Company Act Release No. 17452 (Apr. 23, 1990).

[22] *See* Rule 22e-4(b)(1)(ii). Under the Proposal, a fund would have been required to classify its portfolio investments on an investment-by-investment basis.

[23] The Liquidity Program Release distinguishes between asset classes and sub-classes, noting that a fund's procedures "should incorporate sufficient detail to meaningfully distinguish between asset classes and sub-classes."

[24] In determining the relevant asset classes, the Commission does not consider it appropriate for a fund to use "very general asset class categories," citing "equities" and "fixed income" in the Liquidity Program Release as examples of overly generalized asset classes. In this regard, the Commission suggests that a fund may wish to distinguish equity securities, for example, based on such factors as the market(s) in which the securities' issuer is based, market capitalization, and whether the stock is common or preferred. Moreover, the Commission expects that there are some asset classes that have such a wide range of liquidity characteristics that each position would need to be classified individually, referring specifically in the Liquidity Program Release to asset classes "encompassing some bespoke complex derivatives or complex structured securities."

[25] *See* Rule 22e-4(b)(1)(ii).

Review of Liquidity Classifications. Under the Liquidity Rule, a fund is required to review its liquidity classifications at least monthly in connection with reporting its liquidity classifications on Form N-PORT, taking into account relevant market, trading and investment-specific considerations. The minimum monthly review requirement differs from the Proposal, which would have required a fund to conduct a review on an "ongoing basis." In addition, a more frequent review is required to the extent that market-related and other changes are reasonably expected to materially affect a fund's investment classifications.

Highly Liquid Investment Minimum (HLIM)

The Liquidity Rule requires each fund, other than In-Kind ETFs and funds that "primarily" hold highly liquid assets, to determine a minimum amount of the fund's net assets that must be invested in highly liquid investments that are assets.[26]

This requirement reflects a modification of the "three-day liquid asset minimum" under the Proposal, which would have required a fund to determine the percentage of its net assets that must be invested in relatively liquid assets ("three-day liquid assets"). As in the case of the proposed three-day liquid asset minimum, the Commission believes that the HLIM requirement, as adopted, will increase the likelihood that a fund would be prepared to meet redemption requests without significant dilution of remaining investors' interests in the fund. According to the Commission, the HLIM is not meant to suggest that a fund should only, or primarily, use its most liquid investments to meet shareholder redemptions.

HLIM Determination. In determining its HLIM, a fund is required to consider the same Liquidity Risk Factors that the fund must consider in assessing, managing and reviewing its liquidity risk. For illustrative purposes, with respect to the Investment Strategy Factor, the Commission generally believes that the less liquid a fund's overall portfolio investments, the higher the fund may want to establish its HLIM. Moreover, the Liquidity Rule provides that a fund is required to consider the Investment Strategy and Cash Flow Factors as they apply during normal conditions and during stressed conditions but, in a change from the Proposal, only to the extent stressed conditions are reasonably foreseeable *during the period until the next review of the HLIM* (emphasis added). The Commission does not provide a range of what it considers to be an appropriate HLIM, as this is a determination that must be made by each fund based on its assessment of the Liquidity Risk Factors under the particular facts and circumstances; however, the Commission continues to generally believe that it would be "extremely difficult" for a fund to conclude that an HLIM of zero would be appropriate.

Shortfall Policies and Procedures. A fund is required to adopt specific policies and procedures for responding to a shortfall in the fund's assets that are highly liquid investments (Shortfall Procedures). In contrast with the Proposal, a fund that falls below its HLIM (HLIM Shortfall) will *not* be limited to acquiring only highly liquid investments, if acquiring other investments would be consistent with the fund's Shortfall Procedures.

The Liquidity Rule provides flexibility as to the particular Shortfall Procedures a fund may adopt, in recognition that different facts and circumstances could result in different funds taking varying approaches to address a decline in assets that are highly liquid investments. The Commission suggested that Shortfall Procedures could

[26] *See* Rule 22e-4(b)(1)(iii). Rule 22e-4(a)(7) and (b)(1)(iii) refers to "investments that are assets" to make clear that, when evaluating whether a fund is meeting its HLIM, the fund should look to its investments with positive values. Rule 22e-4(b)(1)(iv) also makes reference to investments that are "assets" in connection with the 15% limit on illiquid investments, as described below, to make clear that the 15% limit applies to investments with positive values. The phrase "that are assets" is generally not included in the remainder of this *Alert*.

specify, among other things: (i) actions that a fund may take in response to an HLIM Shortfall; (ii) market- and fund-specific circumstances that may shape a fund's response to an HLIM Shortfall; (iii) the timeframe by which a fund plans to come back into compliance with its HLIM; and (iv) the persons who will determine how to respond to an HLIM shortfall.

Periodic Review of HLIM. A fund is required to periodically review, no less frequently than annually, the fund's HLIM. The Proposal would have required at least semi-annual review. This minimum annual review period correlates with the requirement for a fund to review its liquidity risk at least annually, thereby reducing compliance burdens that could arise from disparate review periods.

Exclusion for Funds Primarily Holding Assets that are Highly Liquid Investments. Under the Liquidity Rule, a fund that "primarily" holds assets that are highly liquid investments is excluded from the requirements to determine and review an HLIM and adopt Shortfall Procedures.[27] Although the Commission does not define "primarily" or list specific types of funds that categorically meet this exclusion, the Commission's view, as expressed in the Liquidity Program Release, is that a fund that holds less than 50% of its assets in highly liquid investments would be unlikely to qualify as "primarily" holding assets that are highly liquid investments. The Commission anticipates that a fund that considers itself to fall within this exclusion would address in its Liquidity Program how it meets the exclusion, including, how it defines "primarily." Importantly, the Liquidity Rule provides that, for purposes of determining whether a fund holds primarily highly liquid investments, the fund must exclude from its calculations highly liquid investments that it has segregated to cover, or pledged to satisfy margin requirements in connection with, derivatives transactions that the fund has classified in buckets other than the "highly liquid" category.

15% Limit on Illiquid Investments

The Liquidity Rule sets a limit on the ability of a fund to acquire "illiquid investments" (as defined above under "*Liquidity Classification Categories*").[28] Specifically, a fund is prohibited from acquiring any illiquid investment if, immediately after the acquisition, the fund would have invested more than 15% of its net assets in illiquid investments that are assets.[29] If a fund's holdings of illiquid investments exceed 15% of its net assets, a fund would not be required to divest illiquid investments. A fund is only prohibited from acquiring an illiquid investment once it crosses the 15% limit on illiquid investments.

The 15% limitation is similar to the Proposal's limitation on so-called "15% standard assets" in that both requirements limit a fund's acquisition of assets that cannot be sold or disposed of within seven days, thereby increasing the likelihood that the fund holds adequate liquid assets to meet redemption requests without significant dilution of remaining investors' interests in the fund. However, there are key differences between the Proposal and the final Liquidity Rule. In particular, the Liquidity Rule, as adopted, incorporates an "illiquid investments" category into the general framework for classifying the liquidity of a fund's portfolio investments, thereby harmonizing the classification process across the full liquidity spectrum. This is a departure from the Proposal, which would have required a fund to identify 15% standard assets in a process separate from the requirements to classify the liquidity of a fund's portfolio assets.

---

27 *See* Rule 22e-4(b)(1)(iii).

28 *See* Rule 22e-4(b)(1)(iv).

29 *See* footnote 27 above regarding the use of the phrase, "investment that are assets."

Withdrawal of Long-Standing 15% Commission Guideline. In the Liquidity Program Release, the Commission withdrew its long-standing guideline and related guidance that generally limits a fund from investing more than 15% of its net assets in "illiquid assets," defined as assets that cannot be sold or disposed of in the ordinary course of business within seven days.[30] The Commission replaced this guideline with a new definition of "illiquid investments" and new regulatory requirements with respect to a fund's exposure to illiquid investments, as summarized above.

Other Important Aspects of Liquidity Rule and Liquidity Program Release

Policies and Procedures Regarding Redemptions In-Kind. The Liquidity Rule requires a fund that engages in, or reserves the right to engage in, in-kind redemptions to meet shareholder redemption requests to adopt and implement written policies and procedures regarding in-kind redemptions as part of the management of its liquidity risk.[31] In the Liquidity Program Release, the Commission indicates that well-designed policies and procedures would address a variety of issues and circumstances, including, but not limited to, the following:

- the particular circumstances in which a fund might employ in-kind redemptions, including, for example, whether the fund would use in-kind redemptions at all times, or only under stressed conditions, and what types of events may lead the fund to redeem in-kind;
- whether a fund would use in-kind redemptions for all redemption requests or only for requests over a certain size;
- the ability of investors to receive in-kind redemptions, potentially including different procedures for different shareholder types (*e.g.*, retail versus institutional investors and accounting for investors that invest in the funds through omnibus accounts);
- potential operational issues with providing in-kind redemptions to various kinds of investors, such as through notifications to large shareholders that may be subject to redemptions in-kind and setting up securities transfer processes for those shareholders in advance; and
- how a fund would determine which securities it would use in an in-kind redemption (*e.g.*, illiquid or restricted securities), or whether it plans to redeem securities in kind as a *pro rata* ratio of the fund's securities holdings, or whether it would redeem in a non-*pro rata* manner.

Cross Trades. The Liquidity Program Release includes guidance relating to the use of cross trades under Rule 17a-7 under the 1940 Act, particularly in the context of cross trades involving less liquid securities.[32] The guidance notes that a key condition of Rule 17a-7 is that market quotations must be readily available for each traded security and that if the security is only traded over the counter, the cross trade must be conducted at the average of the highest current independent bid and lowest current independent offer determined on the basis of reasonable inquiry (the 17a-7 Pricing Condition). In the Liquidity Program Release, the Commission noted that "evaluated prices provided by pricing services are not, by themselves, readily available market quotations" for

---

30 *See* Revisions of Guidelines to Form N-1A, Investment Company Act Release No. 18612 (Mar. 12, 1992).

31 *See* Rule 22e-4(b)(1)(v).

32 Note that the Commission did not amend Rule 17a-7 but, rather, issued guidance as to the Commission's views, as described in this *Alert*.

purposes of satisfying the 17a-7 Pricing Condition. [33] The Commission also indicated that less liquid assets "are less likely to trade in highly active markets that produce readily available market quotations, which may make it more difficult to ensure that the terms of a cross-trade transaction are fair and reasonable to each participating investment company or other advisory client and do not involve overreaching." In this regard, although the Commission stopped short of indicating that cross trades in less liquid assets could not meet the conditions of Rule 17a-7, the Commission noted that "it may be prudent for advisers to subject less liquid assets to careful review (and potentially even a heightened review compared to other more liquid assets) before engaging in such transactions."[34]

The Commission also noted that cross trading implicates a fund's adviser's duty to seek best execution for each fund or other advisory client, as well as its duty of loyalty to each fund or other advisory client. The Commission stated that an adviser should not cause funds or other clients to enter into a cross trade unless doing so would be in the best interests of each fund or other client participating in the transaction. Advisers should be particularly sensitive to the possibility of heightened conflicts when one or both of the clients is experiencing stress at the time of consideration of a cross trade.

Recordkeeping Requirements. The Liquidity Rule requires each fund to maintain a written copy of the policies and procedures adopted as part of its Liquidity Program, including its Shortfall Procedures.[35] Additionally, the Liquidity Rule requires each fund to maintain copies of any materials provided to its board in connection with the board's initial approval of the fund's Liquidity Program, as well as copies of written reports provided to the board regarding the adequacy of the fund's Liquidity Program. The Liquidity Rule also requires that a fund maintain a written record of policies and procedures related to how its HLIM, and any adjustments thereto, were determined, as well as records of any materials provided to the board related to an HLIM Shortfall.[36]

Board Responsibilities under the Liquidity Rule

The Liquidity Rule and the Liquidity Program Release include specific requirements and guidance with respect to a board's oversight of a fund's Liquidity Program. It is important to note that a board's responsibilities under the final Liquidity Rule have been meaningfully scaled back from those specific requirements that would have attached under the Proposal. In this regard, the Liquidity Program Release makes clear that the Commission believes "the role of the board under the rule is one of general oversight, and consistent with the obligations [the Commission] expects that directors will exercise their reasonable business judgment in overseeing the program on behalf of the fund's investors." As discussed below, the Liquidity Rule, as adopted, eliminates certain specific board approval requirements that would have been imposed under the Proposal.

---

[33] The staff of the Commission has provided exceptions to this requirement in no-action letters permitting the use of pricing services in limited circumstances. *See, e.g.*, United Municipal Bond Fund (pub. avail. Jan. 27, 1995).

[34] The Commission also indicated that a fund's Rule 38a-1 compliance policies and procedures related to Rule 17a-7 generally should contemplate how the fund meets the Rule 17a-7 requirements with regard to less liquid assets.

[35] *See* Rule 22e-4(b)(3)(i) through (iii).

[36] As a general matter, under Rule 22e-4(b)(3), the recordkeeping requirements apply for a period of five years, with certain nuances depending on the nature of the record.

Designation of Liquidity Program Administrator. The Liquidity Rule requires a fund's board to approve the designation of the fund's investment adviser, officer, or officers (which may *not* be solely portfolio managers of the fund) responsible for administering the fund's Liquidity Program (the Program Administrator).[37] The Commission noted that permitting a fund's board to designate a Program Administrator "properly tasks the person(s) who are in a position to manage the fund's liquidity risks on a real-time basis with responsibility for administration of the [Liquidity Program]".

Initial Approval of the Liquidity Program. The Liquidity Rule also requires that a fund's board, including a majority of the "independent trustees," initially approve the fund's Liquidity Program.[38]

Review of the Liquidity Program. The Liquidity Rule requires a fund's board to review, no less frequently than annually, a written report from the Program Administrator that addresses the operation of the Liquidity Program and assesses its adequacy and effectiveness of implementation.[39] In a key change from the Proposal, a board will not be required to approve material changes to a Liquidity Program; instead, such changes should be described in the report from the Program Administrator.

Board Oversight of the HLIM. In a change from the Proposal, a fund's board will *not* be required to approve the HLIM, nor will the board be required to approve changes to the HLIM, except in limited circumstances. Under the Proposal, a fund's board would have been required to approve the "three-day liquid asset minimum" and any changes to the three-day asset minimum, as described above and in the Proposing Release. Under the Liquidity Rule, a fund's board is not required to approve the HLIM or any changes to the HLIM except in circumstances in which the fund seeks to change the HLIM at a time where there is an HLIM Shortfall. The Liquidity Rule also contemplates that, if a fund experiences an HLIM Shortfall for a period of seven consecutive calendar days or less, the Program Administrator would report such HLIM Shortfall to the board at its next regularly scheduled meeting, including an explanation of the cause(s) of the HLIM Shortfall and any actions taken in response. Moreover, to the extent that a fund experiences an HLIM Shortfall for a period of more than seven consecutive calendar days, the Program Administrator must report to the board within one business day thereafter with an explanation of how the fund plans to eliminate the HLIM Shortfall within a reasonable period of time. Finally, the Program Administrator's report to the board on the operation of a fund's Liquidity Program must also address the operation of the HLIM and any changes thereto.

Board Reporting Requirements When a Fund Exceeds the 15% Illiquid Investment Limit. The Liquidity Rule requires a fund that holds more than 15% of its net assets in illiquid investments to report such an occurrence to its board within one business day. This report must include an explanation of the extent and causes of the occurrence and a plan to bring the fund's illiquid investments back into compliance with the 15% limit within a reasonable period of time. In addition, if a fund's illiquid investments exceed the 15% limit for 30 days (and at each consecutive 30-day period thereafter), the fund's board, including a majority of "independent trustees," must assess whether such plan continues to be in the best interest of the fund.

---

[37] *See* Rule 22e-4(b)(2)(ii).

[38] *See* Rule 22e-4(b)(2)(i).

[39] *See* Rule 22e-4(b)(2)(iii).

Section 2: Liquidity Rule Disclosure and Reporting Requirements

The Commission adopted various disclosure and reporting requirements in connection with the Liquidity Rule.

Form N-1A. The Commission adopted amendments to Form N-1A that will require a fund to further describe its procedures for redeeming the fund's shares, including the number of days following receipt of shareholder redemption requests in which the fund typically expects to pay redemption proceeds to redeeming shareholders. Under the amendments, if the number of days a fund expects to pay redemption proceeds differs by method of payment (*e.g.*, check, wire, automated clearing house), the fund will be required to disclose the typical number of days or estimated range of days that the fund expects it will take to pay out redemption proceeds for each method. The Commission noted that this requirement focuses on disclosing when the fund expects to make the payment, not when the shareholder should expect to receive the proceeds, in recognition of the fact that the receipt of proceeds is unlikely to be within the fund's control. The Commission noted that funds may wish to also consider disclosing whether payment of redemption proceeds may take longer than the number of days that the fund typically expects and may take up to seven days, consistent with Section 22(e) of the 1940 Act.

Under the amendments to Form N-1A, a fund will be required to describe the methods the fund typically expects to use to meet redemption requests in stressed and non-stressed market conditions. The Commission noted that methods to meet redemption obligations may include, for example, sales of portfolio assets, holdings of cash or cash equivalents, the use of lines of credit and/or interfund lending, and in-kind redemptions.

New Form N-LIQUID. The Commission adopted a new Rule 30b1-10 under the 1940 Act, which requires a fund to file a current report to the Commission on new Form N-LIQUID when certain significant events related to a fund's liquidity occur. More specifically, a fund is required to file Form N-LIQUID within one business day of the occurrence of one or more of the following events:

- if more than 15% of the fund's net assets are, or become, illiquid investments as defined in the Liquidity Rule;
- if the fund's illiquid investments previously exceeded 15% of net assets, but the fund has since determined that its holdings in illiquid investments have changed to be less than or equal to 15% of its net assets; or
- if the fund's HLIM Shortfall persists for more than seven consecutive calendar days.

A fund's Form N-LIQUID filing will *not* be available to the public.

Form N-PORT. A fund will be required to report on Form N-PORT the following information with respect to its liquidity:

- the liquidity classification for each of the fund's positions[40]; and
- the fund's HLIM, if applicable, and the number of days on which the fund experienced an HLIM Shortfall during the reporting period, as well as whether the fund's HLIM changed during the period.[41]

[40] In contrast with the Proposal, position-level liquidity classifications will be reported to the Commission on a non-public basis. Form N-PORT will also include reporting of aggregate percentages of a fund's portfolio investments in each liquidity category, which will, unlike the position-specific classifications, be available to the public on a 60-day delay.

Form N-CEN. A fund will be required to report on Form N-CEN information regarding the fund's use of lines of credit, interfund lending and interfund borrowing. If a fund reports that it has access to a line of credit, for each line of credit the fund will be required to report whether the line of credit is a committed or uncommitted line of credit. The fund will be required to report information concerning the size of the line of credit in U.S. dollars, the name of the institution(s) with which the fund has the line of credit, and whether the line of credit is for that fund alone or is shared among multiple funds. If the line of credit is shared among multiple funds, the fund must disclose the names and SEC file numbers of the other funds (including any series) that may use the line of credit. If the fund responds affirmatively to having available a line of credit, the fund will be required to disclose whether it drew on the line of credit during the reporting period. If the fund drew on that line of credit during the reporting period, the fund will be required to disclose the average dollar amount outstanding when the line of credit was in use and the number of days that line of credit was in use.

In addition, a fund will be required to report whether it engaged in interfund lending or interfund borrowing during the reporting period, and, if so, the average amount of the interfund loan when the loan was outstanding and the number of days that the interfund loan was outstanding.

With respect to ETFs, any ETF that complies with the Liquidity Rule as an In-Kind ETF will be required to identify itself accordingly in reports on Form N-CEN.

A fund's Form N-CEN filing will be available to the public.

Section 3: Compliance Dates

The compliance date for funds to adopt and implement a Liquidity Program depends on the asset size of the overall fund complex (*i.e.*, the "group of related investment companies" of which the fund is a part). The compliance dates (including the compliance date for new Form N-LIQUID) will be December 1, 2018, for fund complexes with $1 billion or more in net assets as of the end of the most recent fiscal year, and June 1, 2019, for fund complexes with less than $1 billion in net assets as of the end of the most recent fiscal year.

Fund complexes with net assets of $1 billion or more as of the end of the most recent fiscal year will be required to begin filing reports on new Forms N-PORT and N-CEN after December 1, 2018, while fund complexes with less than $1 billion in net assets as of the end of the most recent fiscal year will be required to begin filing reports on Form N-PORT after June 1, 2019.

The compliance date for the amendments to Form N-1A will take effect on June 1, 2017, regardless of the size of the overall fund complex.

For additional information or if you have any questions, please contact Robert M. Kurucza at (202) 346-4515 or Jason F. Monfort at (202) 346-4050.

[41] This information will be reported to the Commission on a non-public basis.