

# THE REVIEW OF SECURITIES & COMMODITIES REGULATION

AN ANALYSIS OF CURRENT LAWS AND REGULATIONS  
AFFECTING THE SECURITIES AND FUTURES INDUSTRIES

Vol. 50 No. 2 January 25, 2017

## THE NEW SEC LIQUIDITY RULE

*The new SEC rule will require open-end funds to have formal liquidity risk management programs. In particular, following the compliance date, open-end funds (including ETFs but not money market funds) must adopt and implement a written program reasonably designed to assess and manage the fund's liquidity risk; funds will be required to classify their portfolio investments, including derivatives, into one of four liquidity categories and publicly file these classifications with the SEC; and funds that do not primarily hold highly liquid investments must set a "highly liquid investment minimum" that will be disclosed to the SEC but not the public.*

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On October 13, 2016, the Securities and Exchange Commission adopted new rules, a new form, and amendments to a rule and forms under the Investment Company Act of 1940 designed to promote effective liquidity risk management for open-end funds.<sup>1</sup> The

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<sup>1</sup> Investment Company Liquidity Risk Management Programs, Investment Company Act Rel. No. 32315 (Oct. 13, 2016), available at <https://www.sec.gov/rules/final/2016/33-10233.pdf> (the "Liquidity Release"); Investment Company Swing Pricing, Investment Company Act Rel. No. 32316 (Oct. 13, 2016), available at <https://www.sec.gov/rules/final/2016/33-10234.pdf> (the "Swing Pricing Release"). The Swing Pricing Release will be discussed in a forthcoming article. The SEC at the same open meeting also adopted new rules, and forms and amendments to its rules and forms under the Investment Company Act to modernize the reporting and disclosure of

changes are intended by the SEC to reduce the risk that open-end funds will be unable to meet redemption obligations and to mitigate the potential for dilution of the interests of fund shareholders. This article will focus in particular on new Rule 22e-4 under the Investment Company Act (the "Liquidity Rule"), which requires each open-end fund, including open-end exchange-traded funds ("ETFs") but not including money market funds, to adopt and implement a written liquidity risk management program reasonably designed to assess and

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information by registered investment companies. Investment Company Reporting Modernization, Investment Company Act Rel. No. 32314 (Oct. 13, 2016), available at <https://www.sec.gov/rules/final/2016/33-10231.pdf>.

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manage the fund's liquidity risk (the "Liquidity Program").<sup>2</sup>

There has been a lot of commentary and controversy about the Liquidity Rule.<sup>3</sup> Now that it has been adopted, attention will focus on its implementation. Funds and advisers are left to grapple with assessing the appropriate level of liquidity for each fund, taking current and ever-changing market conditions and investor behavior into account. There is much subjectivity in many of the decisions funds and advisers will need to make, such as whether changing market depth of an instrument can *reasonably* be expected to *significantly* affect the liquidity of an instrument. Funds and their advisers may choose to take a conservative approach to some of these judgment calls, and that could affect performance if funds hold greater cash amounts or modify current strategies to maintain higher levels of liquidity. From a purely legal and regulatory point of view, the Liquidity Rule mandates new policies and procedures that need to be tailored to particular circumstances and kept evergreen. A Rule 38a-1-like initial and ongoing review process must be followed for implementing the Liquidity Rule, and the board and SEC reporting and record-keeping requirements are significant.

This article is intended to provide a summary of the Liquidity Rule. We suspect that the extended compliance dates (*see* page 23, *infra*) recognize the extensive effort even the best-resourced firms will have to make to implement the Liquidity Rule.

## LIQUIDITY RISK MANAGEMENT PROGRAMS

The Liquidity Rule requires each open-end fund (including ETFs but not money market funds), to adopt

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<sup>2</sup> The Liquidity Rule was adopted unanimously.

<sup>3</sup> For additional background on the rule as proposed, *see* Open-End Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release, Investment Company Act Rel. No. 31835 (Sept. 22, 2015), *available at* <https://www.sec.gov/rules/proposed/2015/33-9922.pdf> (the "Proposing Release"). The Liquidity Rule and the swing pricing rule were both proposed in the Proposing Release, but were adopted in separate releases.

and implement a Liquidity Program reasonably designed to assess and manage the fund's liquidity risk.<sup>4</sup> As adopted, the term "liquidity risk" means "the risk that the fund could not meet requests to redeem shares issued by the fund without significant dilution of remaining investors' interests in the fund."<sup>5</sup> The Liquidity Rule requires a Liquidity Program to include:

- 1) the assessment, management, and periodic review of a fund's liquidity risk;
- 2) the classification of the liquidity of each fund's portfolio investments into one of four categories based on the amount of time needed to convert the instrument to cash, as well as at least monthly reviews of the fund's liquidity classifications;
- 3) the establishment and periodic review of a highly liquid investment minimum for the fund — *i.e.*, the percentage of its net assets that the fund invests in highly liquid investments that are assets;

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<sup>4</sup> The Liquidity Rule does not apply to closed-end funds, but will apply to principal underwriters and depositors of unit investment trusts ("UITs") to a limited degree. The Liquidity Rule requires that, on or before the date of the initial deposit of portfolio securities into the UIT, the principal underwriter or depositor must determine that the portion of the illiquid investments that 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, and must maintain a record of that determination for the life of the UIT and for five years thereafter. Rule 22e-4(c). References to "funds" in this article refer solely to open-end funds.

<sup>5</sup> Rule 22e-4(a)(11). This definition of liquidity risk is changed from the proposed consideration of whether the fund could meet redemption requests without materially affecting the Fund's net asset value ("NAV"). The SEC believes that: (1) the inclusion of a conceptual relationship between liquidity and sale price in the definition of "liquidity risk" is appropriate given that common definitions of liquidity include considerations of the value impact or costs from trading an investment and (2) "significant" conveys more effectively than "materially" that the definition is not meant to reference slight NAV movements, while avoiding the confusion around the term "materially." Liquidity Release, at 58-59, 61.

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- 4) a limitation on the fund’s investment in illiquid investments that are assets to no more than 15% of the fund’s net assets; and
  - 5) for funds that engage in redemptions in-kind, the establishment of policies and procedures regarding how they will engage in such transactions.<sup>6</sup>

These five elements, along with other requirements under the Liquidity Rule, are further discussed below.

### **1. Assessment, Management, and Review of Liquidity Risk**

Each fund under the Liquidity Rule, including ETFs that redeem in-kind (“In-Kind ETFs”),<sup>7</sup> must assess, manage, and periodically review — with such review occurring no less frequently than annually — its liquidity risk. This assessment and review must include consideration of the following factors, as applicable (together, the “Liquidity Risk Factors”):

- the fund or In-Kind ETF’s investment strategy and liquidity of portfolio investments during both normal and reasonably foreseeable stressed conditions,<sup>8</sup> including —

- whether the investment strategy is appropriate for an open-end fund,
- the extent to which the strategy involves a relatively concentrated portfolio or large positions in particular issuers, and
- the use of borrowings for investment purposes and derivatives;<sup>9</sup>

- short-term and long-term cash flow projections during both normal and reasonably foreseeable stressed conditions;<sup>10</sup>
- holdings of cash and cash equivalents, as well as borrowing arrangements and other funding sources;<sup>11</sup> and

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experience may not necessarily be indicative of future outcomes, depending on changes in market conditions and the fund’s particular circumstances.” Liquidity Release, at 75. The SEC noted that “stressed conditions” will likely entail different scenarios for different types of funds. *Id.*

<sup>9</sup> This language is intended to make clear that funds should consider all derivatives, including those used for hedging purposes. Liquidity Release, at 72. Borrowings for investment purposes include bank borrowings and financing transactions such as reverse repurchase agreements and short sales. *Id.* at 73.

<sup>10</sup> The Liquidity Release provides factors as guidance for considering the impact of cash flows on liquidity. These factors include: (1) the size, frequency, and volatility of historical purchases and redemptions of fund shares during normal and reasonably foreseeable stressed periods; (2) the fund’s redemption policies; (3) the fund’s shareholder ownership concentration; (4) the fund’s distribution channels; and (5) the degree of certainty associated with the fund’s short-term and long-term cash flow projections. Liquidity Release, at 78.

<sup>11</sup> Entering into borrowing or other funding arrangements, in the SEC’s view, could assist a fund in meeting redemption requests in certain cases (*e.g.*, by bridging any timing mismatches between when a fund is required to pay redeeming shareholders and when any asset sales that the fund has executed in order to pay redemptions will settle). Liquidity Release, at 85. Funds should consider the likely overall benefits and risks in including borrowing or other funding arrangements within a Liquidity Program. *Id.* at 85-86. In evaluating the extent to which a fund’s borrowing arrangements could help the fund manage its liquidity risk, the SEC highlighted aspects of borrowings for consideration: the terms of the credit facility (*e.g.*, whether the credit facility is committed or uncommitted);

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<sup>6</sup> Liquidity Release, at 42-43.

<sup>7</sup> “In-Kind ETF” means “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.” Rule 22e-4(a)(9). The SEC noted that the relatively small amounts of cash representing the difference between the NAV of a creation unit and the market value of the securities transferred (often referred to as the balancing amount) would be considered *de minimis*. Likewise, to the extent an ETF transferred a *pro rata* amount of its current cash position, the transaction would be considered an “in-kind” transaction not subject to the *de minimis* limitation. The SEC noted, however, that “an ETF that normally redeems in-kind, but delivers all cash to a single authorized participant that elects to receive cash, would not be an ETF that uses a *de minimis* amount of cash. However, depending on the circumstances, an ETF that delivers cash only on one occasion may be able to conclude that it qualifies as an In-Kind ETF in later years if such circumstances are not repeated.” Liquidity Release, at 266-67.

<sup>8</sup> For example, the SEC explained that “if a fund’s portfolio strategy involves investing in securities whose liquidity is likely to decline in stressed conditions, a fund should take this into account in determining how its portfolio liquidity could contribute to its overall liquidity risk. . . . In considering normal and reasonably foreseeable stressed conditions, funds should consider historical experience but should recognize that such

- for **ETFs only**, (1) 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 (2) the effect of the composition of baskets on the overall liquidity of the ETF’s portfolio.<sup>12</sup>

Unless a particular factor is not applicable to a particular fund (e.g., the use of borrowing for investment purposes), it must be considered. Note that, in periodically assessing the investment strategy and liquidity of portfolio investments during both normal and reasonably foreseeable stressed conditions, a fund must take into account whether the fund’s investment strategy is appropriate for an open-end fund.<sup>13</sup> In this regard, the SEC explained that a fund primarily holding securities with extended settlement periods that go beyond seven days — a reference to bank loan funds — may not be appropriately organized as an open-end fund.<sup>14</sup>

## 2. Liquidity Classification of Portfolio Investments

The Liquidity Rule requires funds to adhere to a liquidity classification framework based on a “days-to-cash” determination. In the SEC’s view, these classifications further the goals of “creating a meaningful, uniform framework for reporting to the [SEC] and providing public disclosure about funds’ liquidity profiles.”<sup>15</sup> The SEC also noted that a

classification system representing an evaluation of assets across a liquidity spectrum — as opposed to a binary determination of whether an asset is liquid or illiquid — provides for more meaningful disclosure and reporting on fund liquidity.<sup>16</sup>

*Four Liquidity Categories.* The SEC adopted an approach requiring funds (other than In-Kind ETFs), using information obtained after reasonable inquiry and taking into account relevant market, trading, and investment-specific considerations, to classify each of the fund’s portfolio investments, including each of the fund’s derivatives, into one of four liquidity categories:

**Highly liquid** – Cash and any investment reasonably expected to be convertible to cash<sup>17</sup> in current market conditions in *three business days or less* without the conversion to cash significantly changing the market value of the investment.

**Moderately liquid** – 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.<sup>18</sup>

**Less liquid** – 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*.

**Illiquid** – 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

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the financial health of the institution(s) providing the facility; and whether the facility is shared among multiple funds within a fund family (and the liquidity risk associated with those other funds). *Id.* at 86. The terms and conditions of an interfund lending arrangement, including limitations on the circumstances in which interfund lending may be used, will impact the role that interfund lending has on a fund’s overall Liquidity Program. *Id.* at 86.

<sup>12</sup> Rule 22e-4(b)(1)(i).

<sup>13</sup> The SEC noted that “[w]hen a fund files its initial registration statement and post-effective amendments thereto with the [SEC’s] Division of Investment Management for review, [SEC] staff could request information from the fund regarding the fund’s basis for determining that its investment strategy is appropriate for the open-end structure . . . .” Liquidity Release, at 69 n.206.

<sup>14</sup> Liquidity Release, at 69-70.

<sup>15</sup> Liquidity Release, at 94.

<sup>16</sup> The SEC noted that the categories are tied to the seven-calendar-day period in which funds are required to satisfy redemption requests from shareholders under Section 22(e) of the Investment Company Act. Liquidity Release, at 99.

<sup>17</sup> “Convertible to cash” means “the ability to be sold, with the sale settled.” Rule 22e-4(a)(3).

<sup>18</sup> If an investment could be viewed as either a highly liquid investment or a moderately liquid investment (depending on the calendar or business day convention used), a fund should classify the investment as a highly liquid investment. Note to paragraph (b)(1)(ii) of Rule 22e-4.

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sale or disposition significantly changing the market value of the investment.<sup>19</sup>

The requirement that a fund take into account “relevant market, trading, and investment-specific considerations” in classifying and reviewing its portfolio investments’ liquidity, rather than the prescribed list of factors in the proposal, is meant to allow for a “principles-based” approach.<sup>20</sup>

The SEC noted that a fund could use third-party service providers that provide data and analyses related to investment liquidity to inform or supplement its own consideration of the liquidity of an asset class or investment, but that a fund would not be required to do so.<sup>21</sup>

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<sup>19</sup> Rule 22e-4(b)(1)(ii).

<sup>20</sup> Liquidity Release, at 102. The proposed rule would have required a fund to take into account the following nine factors, to the extent applicable, when classifying the liquidity of each portfolio position in a particular asset: (1) existence of an active market for the asset, including whether the asset is listed on an exchange, as well 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. *Id.* at 100-01 n.313. The SEC chose not to include these factors in the final rule because doing so “could lead funds to focus too heavily on evaluating certain factors that may not be particularly relevant to the liquidity of a specific fund’s portfolio investments, the evaluation of which may not help produce meaningful outcomes in terms of effective classification.” *Id.* at 102. The SEC notes, however, that a fund could consider these factors in assessing the liquidity of its portfolio investments. *Id.* at 160.

<sup>21</sup> Liquidity Release, at 103. A fund should consider having the person(s) at the fund or investment adviser designated to administer the fund’s Liquidity Program review the quality of any data received from third parties, as well as the particular methodologies used and metrics analyzed by third parties, to determine whether this data would effectively inform or supplement the fund’s consideration of its portfolio holdings’ liquidity characteristics. *Id.* at 103-04.

As discussed below, the fund’s liquidity classifications would be filed monthly on Form N-PORT, with the classifications modified as necessary to reflect changes in the liquidity of assets. The information would be available to the public quarterly.

*Liquidity Categorization by Asset Class v. Individual Security.* In an important change from the proposal, a fund may generally classify and review its portfolio investments, including the fund’s derivatives transactions, according to their *asset class* as opposed to on an individual security basis. However, a fund must separately classify and review an investment if the fund or its adviser 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 asset class (*e.g.*, if the market for a particular security is exceptional in terms of size or depth, or if the bid/ask spreads are generally wider or narrower as compared to other securities in its asset class).<sup>22</sup> The SEC explained that classifying portfolio investments in general asset class categories, such as “equities,” “fixed income,” and “other,” would be too broad, but classifying equity securities based on market capitalization or fixed income securities based on issuer type or credit quality, for example, could be appropriate.<sup>23</sup> The SEC noted that a “fund’s asset-class-based classification procedures should incorporate sufficient detail to meaningfully distinguish between asset classes and sub-classes.”<sup>24</sup> The SEC also stated that procedures for asset-class-based classification should include a process for updating these classifications as relevant market, trading, and investment-specific considerations warrant.<sup>25</sup>

*Market Depth as Liquidity Consideration.* The Liquidity Rule requires funds to take market depth into account in evaluating an instrument’s liquidity. In other words, the fund must determine whether trading varying portions of a position in a particular portfolio investment or asset class, in sizes that the fund would reasonably anticipate trading, is reasonably expected to significantly affect its liquidity. If so, the fund must take this determination into account when classifying the liquidity of that investment or asset class.<sup>26</sup> This means that, if a

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<sup>22</sup> Rule 22e-4(b)(1)(ii)(A).

<sup>23</sup> Liquidity Release, at 136-37.

<sup>24</sup> Liquidity Release, at 136.

<sup>25</sup> Liquidity Release, at 137.

<sup>26</sup> Rule 22e-4(b)(1)(ii)(B).

fund determines that the market depth for the 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.<sup>27</sup>

#### *Liquidity Classification of Segregated/Pledged Assets.*

In an important change from the proposal, a fund can categorize an investment as highly liquid even if it is segregated or pledged to support an investment that is not categorized as highly liquid. Nonetheless, the Liquidity Rule requires that a fund must identify the percentage of the fund's 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 a bucket other than highly liquid (*i.e.*, moderately liquid, less liquid, or illiquid). For purposes of calculating these percentages, a fund that has segregated or pledged highly liquid investments and non-highly liquid investments to cover derivatives transactions classified as moderately liquid, less liquid, or illiquid investments should first apply segregated or pledged assets that are highly liquid investments to cover these transactions, unless it has specifically identified segregated non-highly liquid investments as covering such derivatives transactions.<sup>28</sup>

*Use of ETFs to Manage Liquidity.* Certain funds with investment strategies involving relatively less liquid portfolio securities, including micro-cap equity funds, high-yield bond funds, and bank loan funds, may invest a portion of their assets in ETFs with strategies similar to the fund's investment strategy because they view ETF shares as having characteristics that enhance the liquidity of the fund's portfolio.<sup>29</sup> In the Liquidity Release, the SEC raises a word of caution on over-reliance on this practice, suggesting that funds relying substantially on ETFs to manage liquidity risk may not be appropriate in certain market conditions. The Liquidity Release highlights that, in times of declining market liquidity, an ETF may be impaired based on factors not directly related to the liquidity of the ETF's underlying securities.<sup>30</sup> In light of this, the SEC

“encourages” funds to assess the liquidity characteristics of an ETF's underlying securities, as well as the characteristics of the ETF shares themselves, in classifying the liquidity of ETF shares under the Liquidity Rule.<sup>31</sup>

*Illiquid Investments Redefined.* As further discussed below, with respect to the “illiquid” classification category, the SEC replaced existing guidance with the new regulatory requirements for determining that certain investments are illiquid.<sup>32</sup> As a result of the Liquidity Rule's new definition of “illiquid,” the SEC noted that when relevant market, trading, and investment-specific considerations, as well as market depth, are taken into account, some funds may conclude that a greater percentage of their holdings are illiquid.<sup>33</sup>

### **3. Highly Liquid Investment Minimum**

All funds subject to the Liquidity Rule, except In-Kind ETFs and funds that primarily hold highly liquid investments,<sup>34</sup> must set a “highly liquid investment minimum,” or the minimum amount of the fund's net assets that the fund invests in highly liquid investments that are assets,<sup>35</sup> considering the Liquidity Risk Factors,

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useful to funds in managing purchases and redemptions under certain conditions (*e.g.*, ETFs' settlement times could more closely reflect the time in which a fund has disclosed that it will typically redeem fund shares). *Id.*

<sup>31</sup> Liquidity Release, at 163.

<sup>32</sup> Liquidity Release, at 124.

<sup>33</sup> Liquidity Release, at 123.

<sup>34</sup> The SEC expects that a fund that considers itself as primarily holding highly liquid investments will address in its Liquidity Program how it determines that it primarily holds assets that are highly liquid, including how it defines “primarily.” The SEC notes that a fund holding less than 50% of its assets in highly liquid investments would unlikely be able to qualify as “primarily” holding assets that are highly liquid investments. Liquidity Release, at 225 n.726. For purposes of determining whether a fund primarily holds assets that are highly liquid investments, a fund must exclude from its calculations the percentage of the fund's assets that are highly liquid investments that it has segregated to cover all derivatives transactions that the fund has classified as moderately liquid investments, less liquid investments, and illiquid investments, or pledged to satisfy margin requirements in connection with those derivatives transactions. Rule 22e-4(b)(1)(iii)(B).

<sup>35</sup> The Liquidity Rule uses the term “assets” to make clear that the fund should look to investments with positive values when

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<sup>27</sup> Liquidity Release, at 138. If the fund determined, after conducting the required market depth analysis, that a particular investment should be classified in a less liquid bucket, then that new liquidity classification of a particular investment would apply to the entirety of the fund's position in that investment (not, as proposed, to portions of that position). *Id.* at 142.

<sup>28</sup> Note to paragraph (b)(1)(ii)(C) of Rule 22e-4.

<sup>29</sup> Liquidity Release, at 161.

<sup>30</sup> Liquidity Release, at 162. The SEC recognizes, however, that ETFs' exchange-traded nature could make these instruments

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as applicable, noted above.<sup>36</sup> Each fund must separately determine its highly liquid investment minimum. The Liquidity Rule does not set any specific or target minimums for any type of fund, but the SEC noted that a minimum of zero would not be reasonable.<sup>37</sup>

In addition to setting a highly liquid investment minimum, the fund must do the following:

- *Review*: periodically review (no less frequently than annually) the highly liquid investment minimum,<sup>38</sup> and
- *Shortfall policies and procedures*: adopt and implement policies and procedures for responding to a shortfall of the fund’s highly liquid investments below its established minimum (“shortfall policies and procedures”). These policies must include (1) requiring the person(s) in charge of the program to report to the fund’s board of directors no later than its next regularly scheduled meeting with a brief explanation of the causes of the shortfall, the extent of the shortfall, and any action taken in response and (2) if the shortfall lasts more than seven consecutive calendar days, requiring the person(s) in charge of the program to report to the board within one business day thereafter with an explanation of how the fund plans to restore its minimum within a reasonable period of time.<sup>39</sup>

The highly liquid investment minimum may be changed by the fund’s adviser at any time without prior approval of the fund’s board, except during any period of time that the fund’s assets that are highly liquid investments are below the minimum that is in place at the time. Under those circumstances, approval from the fund’s board of directors, including a majority of the independent directors, is necessary to change the minimum.<sup>40</sup> In an important change from the proposal,

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determining whether it meets its highly liquid investment minimum. Highly liquid investments with negative values should not be netted against highly liquid investments with positive values, meaning only highly liquid investments that have positive values (*i.e.*, assets) should be used in the numerator. Liquidity Release, at 195 and accompanying notes.

<sup>36</sup> Rule 22e-4(b)(1)(iii)(A)(1).

<sup>37</sup> Liquidity Release, at 213.

<sup>38</sup> Rule 22e-4(b)(1)(iii)(A)(2).

<sup>39</sup> Rule 22e-4(b)(1)(iii)(A)(3).

<sup>40</sup> Rule 22e-4(b)(1)(iii)(A)(1).

the Liquidity Rule does not prohibit a fund from acquiring investments other than highly liquid investments if the fund falls below its minimum.<sup>41</sup> This latitude is not unfettered, however; failing to restore the minimum for seven consecutive days will require providing the board with a plan to restore it. Moreover, the Liquidity Rule does not require a fund to use its most liquid investments to satisfy shareholder redemptions.<sup>42</sup>

As discussed below, a fund’s highly liquid investment minimum filed on Form N-PORT would not be disclosed to the public, but could be monitored by the SEC and compared to other funds.

The SEC commented that certain investment management practices may require certain funds to maintain a larger highly liquid investment minimum than others. For funds that use borrowings for investment purposes, for example, the SEC’s view is that a fund employing leverage through bank borrowings or derivatives generally would need a larger highly liquid investment minimum than an unleveraged fund.<sup>43</sup> Similarly, a fund that has or expects to have a significant amount of highly liquid investments segregated to cover derivatives transactions or pledged to satisfy margin requirements in connection with derivatives transactions is advised to take into account the fact that such segregated or pledged highly liquid investments may not be available to meet redemptions. Also, it might be sensible for funds with a concentrated shareholder base — with a high risk that a limited number of shareholders redeeming could require the fund to sell a significant

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<sup>41</sup> Liquidity Release, at 202. A fund’s shortfall policies and procedures could outline some of the circumstances in which such action would be appropriate. For example, a fund may reasonably expect inflows in the near term (*e.g.*, from a retirement plan platform) and determine it is acceptable to pursue an attractive buying opportunity for assets that are not highly liquid investments despite a decline below the fund’s highly liquid investment minimum that is expected to be short-term. *Id.* at 220.

<sup>42</sup> Liquidity Release, at 202.

<sup>43</sup> Liquidity Release, at 208. In the SEC’s view, compared to an unleveraged fund, a leveraged fund has an increased risk of being unable to meet redemptions and an increased risk of investor dilution. As support, the SEC cites the fact that a leveraged fund may be subject to margin calls if a security securing the loan declines in value. Margin calls can thus reduce highly liquid portfolio assets available to meet investor redemptions, which can increase dilution and the risk the fund will be unable to meet redemptions. *Id.*



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amount of assets — to designate a larger highly liquid investment minimum.<sup>44</sup>

The SEC views the Liquidity Rule’s shortfall policies and procedures requirement, including the board reporting obligation, as a way to foster discussion among the fund’s management (and board) if the fund falls below its highly liquid investment minimum.<sup>45</sup> The Liquidity Rule provides funds flexibility to take different approaches to their shortfall policies and procedures. Funds could identify and pursue different responses to a highly liquid investment minimum shortfall under different conditions, based on market- and fund-specific circumstances giving rise to a particular shortfall.<sup>46</sup> For example, a fund may: (1) consider selling certain less liquid holdings and purchasing highly liquid investments with the proceeds over a period of time or (2) establish a time frame for bringing the fund’s mix of assets back up to its highly liquid asset minimum.<sup>47</sup>

#### 4. Limitation on Illiquid Investments

All funds subject to the Liquidity Rule, including In-Kind ETFs, may not acquire any illiquid investment if, immediately after the acquisition, the fund or In-Kind ETF would have invested more than 15% of its net assets in illiquid investments that are assets (the “Illiquid Asset Limit”).<sup>48</sup> In addition to limiting the *acquisition*

of illiquid investments, the Liquidity Rule requires SEC reporting of illiquid *holdings* above 15% of a fund’s net assets. If a fund or In-Kind ETF holds more than 15% of its net assets in illiquid investments that are assets:

- the person(s) in charge of the Liquidity Program must report such occurrence to the fund’s board within one business day of the occurrence, with an explanation of the extent and causes of the occurrence, and how the fund plans to bring its portfolio within the Illiquid Asset Limit within a reasonable period of time;<sup>49</sup>
- if the fund still exceeds the Illiquid Asset Limit 30 days from the occurrence (and at each consecutive 30-day period thereafter), the fund’s board, including a majority of the independent directors, must assess whether the plan (noted above) continues to be in the best interest of the fund;<sup>50</sup> and
- if more than 15% of a fund’s net assets are, or become, illiquid investments, then the fund must report to the SEC on a non-public basis on Form N-LIQUID within one business day.

In adopting the Illiquid Asset Limit and its new requirements, the SEC withdrew its past, long-standing guidelines that generally limited an open-end fund’s aggregate holdings of “illiquid assets” to no more than 15% of the fund’s net assets.<sup>51</sup>

#### 5. Redemptions In-Kind

Adopted largely as proposed, the Liquidity Rule requires that each fund subject to the rule that engages in, or reserves the right to engage in, redemptions in-kind must establish policies and procedures regarding how and when it will engage in such redemptions in-

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<sup>44</sup> Liquidity Release, at 209.

<sup>45</sup> Liquidity Release, at 217.

<sup>46</sup> Liquidity Release, at 219.

<sup>47</sup> Liquidity Release, at 220.

<sup>48</sup> Rule 22e-4(b)(1)(iv). The limitation on illiquid investments is similar to the limitation on “15% standard assets” in the proposed rule, in that both requirements limit the acquisition of assets that cannot be sold or disposed of within seven days. As noted above, the Liquidity Rule defines an “illiquid investment” as “any investment that the fund reasonably expects cannot 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.” Rule 22e-4(a)(8). The SEC believes that funds will be less likely to interpret “significant changes” in market value as capturing very small movements in price. Liquidity Release, at 107. Under the proposed rule, a “15% standard asset” was defined as “an asset that may not be sold or disposed of in the ordinary course of business within seven calendar days at approximately the value ascribed to it by the fund.” *Id.* at 231 n.748. However, the proposed rule would have had a fund identify 15% standard assets in a process separate from the liquidity classification process, whereas the Liquidity Rule incorporates the classification of portfolio investments as

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*footnote continued from previous column...*

illiquid into the general liquidity classification process. *Id.* at 231. This harmonization, in the SEC’s view, will reduce confusion that could arise as a result of separate requirements and provide a more comprehensive framework for funds to evaluate the liquidity of their investments. *Id.* at 234.

<sup>49</sup> Rule 22e-4(b)(1)(iv)(A).

<sup>50</sup> Rule 22e-4(b)(1)(iv)(B).

<sup>51</sup> Liquidity Release, at 17. Under the withdrawn “15% guideline,” a portfolio security or other asset was considered illiquid if it could not be sold or disposed of in the ordinary course of business within seven days at approximately the value at which the fund had valued the investment. *Id.*



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kind.<sup>52</sup> The SEC noted that effective policies and procedures on in-kind redemptions would contemplate a variety of issues and circumstances, including, but not limited to:

- whether a fund would use in-kind redemptions at all times, or only under stressed conditions, and what types of events may lead the fund to use them;
- 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 v. institutional investors or holdings through omnibus accounts), and address methods for dealing with potential operational issues with providing in-kind redemptions to certain shareholders;
- which types of securities it would use in an in-kind redemption (*e.g.*, illiquid or restricted securities), or whether the fund plans to redeem securities in-kind as a *pro rata* ratio of the fund's securities holdings, and if so, how to process transactions in odd lots;
- to the extent a fund chooses not to redeem *pro rata*, a process that addresses that securities redeemed are selected and distributed in a manner that is fair and does not disadvantage either the redeeming shareholders or the remaining investors in the fund;
- how the fund would determine that shareholders are treated fairly and are not redeemed with securities the fund deems undesirable or securities that have significant tax consequences; and
- how the fund evaluates the tax consequences to the fund and the redeeming shareholder of distributing certain securities (*e.g.*, whether distributing securities that have significant capital gains or losses built in would have inequitable results).<sup>53</sup>

## 6. Other Requirements of the Liquidity Rule

*Cross Trades.* The Liquidity Release addressed cross trades of less liquid securities pursuant to Rule 17a-7 under the Investment Company Act. A fundamental requirement of Rule 17a-7 is that permitted cross trades

be executed at a security's current market price. In the SEC's view, cross trades involving certain less liquid assets may not be eligible to rely on the rule, as less liquid assets are not as likely to trade in highly active markets that produce readily available market quotations.<sup>54</sup> Though the SEC acknowledged that an assessment of an asset's liquidity, without more, would not determine whether an asset is eligible for a cross-trade transaction under Rule 17a-7, the SEC noted that it may be prudent for a fund's adviser to subject less liquid assets to a heightened review before engaging in such transactions.<sup>55</sup>

*Role of the Fund's Board.* The Liquidity Rule clearly and unambiguously states that the fund board's role is to provide "general oversight" of the Liquidity Program, in light of their reasonable business judgment.<sup>56</sup> Consistent with this approach, the Liquidity Rule eliminates certain of the more detailed approval requirements contained in the proposal, such as requiring that the board approve (1) material changes to the program and (2) the initial highly liquid investment minimum or changes to it, except in limited circumstances.<sup>57</sup> However, each fund's board, including a majority of the independent directors, must:

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<sup>54</sup> Liquidity Release, at 245. The SEC stated that the "quality of dealer quotations may vary depending upon, among other things, the extent to which a dealer makes a market in or retains an inventory in the particular security, or in similar securities, such that the dealer maintains an awareness of changes in market factors affecting the value of the security. 'Indications of interest' and 'accommodation quotes,' may not necessarily reflect the current market values of the securities and thus are not 'market quotations' or 'market values' for the purposes of rule 17a-7." *Id.* at 248. The SEC further noted that "evaluated prices provided by pricing services are not, by themselves, readily available market quotations." *Id.* at 248 n.801.

<sup>55</sup> Liquidity Release, at 246. In the SEC's view, reasonably designed policies and procedures would likely specifically address how a fund would determine that such less liquid securities are appropriately used when meeting the requirements of Rule 17a-7. The specific review of a less liquid asset would likely vary depending on the characteristics of the market or markets in which the asset transacts, the characteristics of the asset itself, and the nature of the funds potentially involved in the cross trade. *Id.* at 247.

<sup>56</sup> Liquidity Release, at 249.

<sup>57</sup> See discussion above in Section 3 on the "Highly Liquid Investment Minimum" describing board approval.

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<sup>52</sup> Rule 22e-4(b)(1)(v).

<sup>53</sup> Liquidity Release, at 241-42.

- *Approve*: initially approve the Liquidity Program;<sup>58</sup>
- *Appoint*: designate the person(s) to administer the program;<sup>59</sup> and
- *Review*: review, no less frequently than annually, a written report prepared by the person(s) in charge of the program that addresses the operation of the program and assesses its adequacy and effectiveness of implementation, including (if applicable) the operation of the highly liquid investment minimum and any material changes to the program.<sup>60</sup>

*Recordkeeping.* Each fund subject to the Liquidity Rule must maintain a written copy of the policies and procedures adopted as part of its Liquidity Program.<sup>61</sup> Each fund must also maintain copies of any materials provided to its board in connection with the board's initial approval of the fund's Liquidity Program and copies of the written reports provided to the board on the adequacy of the fund's Liquidity Program, including the fund's highly liquid investment minimum and the effectiveness of its implementation.<sup>62</sup> Funds will need to keep records of any materials provided to the board related to the fund dropping below its highly liquid investment minimum as well as a written record of how its highly liquid investment minimum and any adjustments thereto were determined, including the fund's assessment and periodic review of its liquidity risk.<sup>63</sup> In general, the record-retention period is five years.

*Disclosure Requirements.* Aspects of a fund's Liquidity Program must be disclosed on new and existing forms, generally in public filings, but in certain circumstances on a confidential basis.

*Form N-1A.* All open-end funds, including ETFs and money market funds, will have to disclose their procedures for redeeming 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.<sup>64</sup> A fund will also be required to describe the methods the fund *typically expects* to use to meet redemption requests in stressed and non-stressed market conditions (*e.g.*, sales of portfolio assets, holding cash, use of credit facilities, and in-kind redemptions).<sup>65</sup> In a change from the proposal, funds will not be required to file credit agreements as exhibits to their registration statements.

*Form N-LIQUID.* Under this new reporting form, open-end funds, including In-Kind ETFs (as applicable) but not including money market funds, are required to file on a non-public basis when certain significant events related to a fund's liquidity occur.<sup>66</sup> Form N-LIQUID is required to be filed within one business day when one or more of the following events occur:

- if the fund exceeds the Illiquid Asset Limit;<sup>67</sup>
- if a fund that previously exceeded the Illiquid Asset Limit determines that its holdings in illiquid investments that are assets have changed to comply with the Illiquid Asset Limit, then the fund is also required to report (1) the date(s) on which its illiquid investments that are assets fell to or below 15% of net assets and (2) the current percentage of the

<sup>58</sup> Directors may satisfy their obligations with respect to this initial approval by reviewing summaries of the Liquidity Program prepared by the fund's investment adviser, officer, or officers administering the program, legal counsel, or other persons familiar with the Liquidity Program. Liquidity Release, at 250.

<sup>59</sup> The administrator may be the fund's investment adviser, officer, or officers (which may not be solely portfolio managers of the fund) responsible for administering the program, and its policies and procedures. Rule 22e-4(a)(13).

<sup>60</sup> Rule 22e-4(b)(2). The board's role is modeled on the role it has for a fund's compliance program under Rule 38a-1. Liquidity Release, at 249.

<sup>61</sup> Rule 22e-4(b)(3)(i). These policies and procedures would need to include any shortfall policies and procedures adopted by the fund.

<sup>62</sup> Rule 22e-4(b)(3)(ii).

<sup>63</sup> Rule 22e-4(b)(3)(iii).

<sup>64</sup> Item 11(c)(7) of Form N-1A. If the number of days in which a fund expects to pay redemption proceeds differs by payment method (*e.g.*, check, wire, automated clearing house), then the fund is 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 used. *Id.*

<sup>65</sup> Item 11(c)(8) of Form N-1A (emphasis added).

<sup>66</sup> This requirement will be implemented through the SEC's adoption of new Rule 30b1-1 under the Investment Company Act, which requires funds to file a report on Form N-LIQUID in certain circumstances. The content of the report is similar to the information proposed to be reported on Form N-PORT concerning a fund's investment in illiquid assets, but with some modifications.

<sup>67</sup> Part A and Part B of Form N-LIQUID.

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fund's net assets that are illiquid investments that are assets;<sup>68</sup> or

- when the fund's holdings in highly liquid investments that are assets fall below the fund's highly liquid investment minimum for more than seven consecutive calendar days, and the date(s) of such occurrence.<sup>69</sup>

*Form N-CEN.* Consistent with the proposal, a fund must report information regarding the use of lines of credit, interfund lending, and interfund borrowing.<sup>70</sup> A fund will also have to report whether the fund is an "In-Kind Exchange-Traded Fund" as defined in Rule 22e-4.

*Form N-PORT.* A fund will be required to report monthly the liquidity classification assigned to each of the fund's portfolio investments individually. Position-level liquidity classification information will be reported to the SEC in a structured data format on a confidential basis rather than, as proposed, released every three months to the public. A fund will be required monthly to report on Form N-PORT the aggregated percentage of its portfolio investments that falls into each of the four liquidity categories, and such aggregate information will be disclosed to the public only for the third month of each fiscal quarter with a 60-day delay.<sup>71</sup> A fund will also be required to report its highly liquid investment minimum monthly on Form N-PORT on a non-public basis.<sup>72</sup>

*Effective and Compliance Dates.* The effective date of Rule 22e-4 is January 17, 2017. The SEC has

adopted tiered compliance dates: for larger entities (*i.e.*, funds that together with other investment companies in the "same group of related investment companies"<sup>73</sup> have net assets of \$1 billion or more at the end of the most recent fiscal year), the compliance date is December 1, 2018; for smaller entities (*i.e.*, funds that, together with other investment companies in the same "group of related investment companies," have net assets of less than \$1 billion as of the end of the most recent fiscal year), the compliance date is June 1, 2019. The amendments to Form N-CEN are effective June 1, 2018.

## CONCLUSION

The Liquidity Rule, along with the swing pricing rule and changes to modernize and enhance fund reporting, is the first part of a series of transformative reforms proposed to enhance the SEC's oversight and regulation of the asset management industry. The adopted Liquidity Rule is less onerous and prescriptive than initially proposed, taking industry comments and concerns into account. Moreover, the rule has been modified to clarify that fund boards would serve in their traditional oversight roles in overseeing the implementation of the rule. Nonetheless, the effect of the Liquidity Rule on how funds are managed and how disclosures of liquidity classifications may affect investor choice is far from clear at this time but could be significant. Despite uncertainties surrounding the rule and its impact, the rule addresses important risk areas as sources of liquidity change and the funds consider how to be prepared to meet redemptions on a timely basis without diluting non-redeeming shareholders. ■

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<sup>68</sup> Part C of Form N-LIQUID.

<sup>69</sup> Part D of Form N-LIQUID.

<sup>70</sup> Item C.20 of Form N-CEN.

<sup>71</sup> Liquidity Release, at 179.

<sup>72</sup> General Instruction F of Form N-PORT.

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<sup>73</sup> "Group of related investment companies" is defined in Rule 0-10 under the Investment Company Act as "two or more management companies (including series thereof) that: (i) hold themselves out to investors as related companies for purposes of investment and investor services and (ii) either: (A) have a common investment adviser or have investment advisers that are affiliated persons of each other or (B) have a common administrator . . . ."