SEC Adopts New Rules and Rule Amendments to Require Registered Open-End Investment Companies to Establish Liquidity Risk Management Programs and Permit Them to use "Swing Pricing"

Authored by Julien Bourgeois, Brendan Fox, Jack Murphy, John O'Hanlon, Stuart Strauss, Allison Fumai, Jeremy Senderowicz, Brenden Carroll, Aaron Withrow, Christine Schleppegrell, Lori Zedeck, Brian McGrady, Jeremy Clemens, Neema Nassiri

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The U.S. Securities and Exchange Commission (SEC or Commission) has unanimously adopted new rules and rule amendments[1] to require registered open-end investment companies (including exchange-traded funds and exchange-traded managed funds[2] but excluding money market funds) to establish liquidity risk management programs. The SEC also adopted, by a 2-to-1 vote, rule amendments to permit – but not require – registered open-end investment companies (excluding money market funds and exchange-traded funds) to use "swing pricing."[3] In addition, the Commission has imposed new disclosure and reporting requirements related to a fund's liquidity risk management program and swing pricing.

The new rules and rule amendments represent significant changes to current liquidity management and reporting requirements and will require significant changes to fund operations, as well as disclosure and reporting requirements. A summary of the new rules and rule amendments is provided below.[4]

Executive Summary

New Rule 22e-4 under the U.S. Investment Company of 1940 (1940 Act) (Liquidity Rule) will require funds to adopt liquidity risk management programs. However, ETFs that qualify as so-called "In-Kind ETFs" (as defined below) and funds that "primarily" hold "highly liquid investments" (as defined below) will be excluded from certain requirements. A fund's liquidity risk management program must be approved by the fund's board of directors/trustees (board), and must include several elements:

- ***Assessment, Management and Periodic Review of Fund's Liquidity Risk***. Relying on certain specified factors, funds will be required to assess, manage and periodically review their "liquidity risk" (as defined below).

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1 *See* Investment Company Liquidity Risk Management Programs, Investment Company Act Rel. No. 32315 (Oct. 13, 2016) (Liquidity Program Adopting Release). On the same day, the Commission adopted, by a 2-to-1 vote, new rules and forms, as well as amendments to certain rules and forms, to modernize the reporting of information by registered investment companies. *See* Investment Company Reporting Modernization, Investment Company Act Rel. No. 32314 (Oct. 13, 2016). For additional information on the SEC's modernization of reporting and disclosure, click here.

2 All references herein to exchange-traded funds (ETFs) include exchange-traded managed funds.

3 *See* Investment Company Swing Pricing, Investment Company Act. Rel. No. 32316 (Swing Pricing Adopting Release).

4 For purposes of this *OnPoint*, unless the context indicates otherwise, registered open-end investment companies, including mutual funds (other than money market funds) and ETFs, are generally referred to herein as "funds."

- ***Liquidity Classification of Fund Investments****.* The Liquidity Rule will require a fund to classify each of its portfolio investments into one of four liquidity categories – “highly liquid investments,” “moderately liquid investments,” “less liquid investments” and “illiquid investments” (each as defined below) – based on the number of days within which the fund can reasonably expect an investment to be convertible to cash (or, for the “less-liquid” and “illiquid” categories, sold or disposed of), without significantly changing the market value of the investment.
- ***Determination of Highly Liquid Investment Minimum.*** Funds will be required to establish a minimum percentage of net assets that must be invested in “highly liquid investments.” Funds will also be required to implement policies and procedures for responding to a “shortfall” in the highly liquid investment minimum.
- ***15% Limit on Illiquid Investments***. The SEC adopted a 15% limit on a fund’s acquisition of “illiquid investments.” Funds will be required to review their illiquid investments at least monthly. If a fund breaches the 15% limit, the occurrence must be reported to the board, together with an explanation of how the fund intends to bring its illiquid investments back into compliance with the 15% limit within a reasonable period of time. Furthermore, if the breach is not resolved within 30 days, the board will be required to assess whether the plan presented is in the best interest of the fund.
- ***Board Approval and Review.*** A fund’s board will be required to approve the fund’s liquidity risk management program and the designation of the fund’s investment adviser or an officer to administer the program. In addition, a fund’s board will be responsible for reviewing a written report (which must be provided at least annually) that discusses the adequacy of the fund’s liquidity risk management program and the effectiveness of its implementation.
- ***New Form N-LIQUID****.* In a departure from the proposed rule, a fund will be required to file with the SEC a report on new Form N-LIQUID when the fund’s level of illiquid investments exceeds the 15% limit or when the fund’s highly liquid investments fall below its minimum percentage of highly liquid investments for more than a brief period of time. This filing would be non-public.
- ***Swing Pricing****.* In addition to the Liquidity Rule, the SEC adopted amendments to Rule 22c-1 under the 1940 Act (Swing Pricing Amendments) to permit “swing pricing” under certain circumstances. Swing pricing generally refers to a mechanism that would adjust the net asset value (NAV) of a fund’s shares to effectively pass on the trading and other costs associated with purchases or redemptions of fund shares to the purchasing or redeeming shareholder.

The compliance date for the Liquidity Rule is December 1, 2018 for fund complexes with $1 billion or more in net assets and June 1, 2019 for fund complexes with less than $1 billion in net assets. Based on operational concerns raised by industry participants, the Commission delayed the effective date of the Swing Pricing Amendments until two years after publication in the Federal Register.

Background and Summary of Industry Comments

The Liquidity Rule, together with the related disclosure and reporting requirements, is generally intended to: (1) promote effective liquidity risk management for funds; (2) limit the risk that funds would be unable to meet shareholder redemption requests; and (3) minimize the potential dilutive impact of shareholder transactions on a fund’s remaining shareholders. These reforms were proposed in response to the growth of the U.S. asset management industry in general, including the growth of less liquid and alternative strategies, as well as the evolution of settlement periods and redemption practices. According to SEC Chair Mary Jo White, “[m]anaging the liquidity of

an investment portfolio is a core responsibility" of funds, and "careful management of portfolio liquidity is essential for meeting" a fund's obligation to satisfy shareholder redemption requests on a daily basis.[5]

The SEC proposed the Liquidity Rule in September 2015 (Proposed Liquidity Rule).[6] While the fund industry generally supported some type of principles-based liquidity risk management program, industry participants, including Dechert LLP,[7] provided extensive comments on certain elements of the Proposed Liquidity Rule. The following summarizes certain comments that were submitted to the Commission, as well as certain changes that are reflected in the Liquidity Rule in response to these comments.

- ***Liquidity Classification of Fund Investments***. Under the Proposed Liquidity Rule, funds would have been required to classify each of the fund's portfolio positions *(or portions of a position)* into one of six liquidity categories, based on the number of days it would take to convert the position (or portion thereof) into cash. This classification would have been required on an investment-by-investment basis. Industry participants opposed this requirement for several reasons, including the belief that liquidity determinations may be speculative, subjective and not easily reduced to the level of granularity required under the Proposed Liquidity Rule (*e.g.*, 2-3 business days versus 4-7 calendar days).[8]

  As adopted, the Liquidity Rule requires funds to: (1) classify each of their portfolio investments into one of *four* liquidity categories – "highly liquid investments," "moderately liquid investments," "less liquid investments" and "illiquid investments;" and (2) assign a liquidity classification to the entirety of a fund's position in a particular investment (not, as proposed, to portions of a position). Moreover, funds will be permitted to classify investments by asset class (rather than on an investment-by-investment basis), unless market, trading or investment-specific considerations with respect to a particular investment are expected to significantly affect the liquidity characteristics of that investment.

- ***The TDLA Minimum***. The Proposed Liquidity Rule would have required each fund to determine its three-day liquid asset minimum (TDLA Minimum) (*i.e.*, the minimum percentage of the fund's net assets that must be invested in cash and securities that are believed to be convertible into cash within three business days). Industry participants opposed these requirements for several reasons, including a belief that a TDLA Minimum: (1) would be unsuitable for funds that primarily invest in liquid asset classes; and (2) would not properly take into account the unique structural aspects of ETFs. In adopting the Liquidity Rule, the Commission replaced the TDLA Minimum with the "highly liquid investment minimum" requirement which, in some respects, is more flexible than the TDLA Minimum. For example, in response to the comments received on the Proposed

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5 *See* Chair Mary Jo White, Statement at Open Meeting: Modernizing and Enhancing Investment Company and Investment Adviser Reporting (Oct. 13, 2016).

6 *See* Open-End Fund 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) (Proposing Release). For additional information regarding the proposal, please refer to *Dechert OnPoint*, SEC Proposes Sweeping Changes to Liquidity Risk Management Practices Used by Mutual Funds and ETFs (Oct. 2015).

7 *See* Comment Letter of Dechert LLP (Jan. 13, 2016) (Dechert Comment Letter). In the Liquidity Program Adopting Release, the Dechert Comment Letter was cited by the SEC approximately 36 times.

8 Certain industry participants also believed that: (1) the Proposed Liquidity Rule would have imposed significant costs and operational burdens – without a clear benefit – on funds; (2) the Proposed Liquidity Rule could have created an environment in which undue reliance is placed on third-party vendors; and (3) the public disclosure of liquidity classifications would not necessarily facilitate comparisons among funds and could be potentially misleading to shareholders.

Liquidity Rule, funds whose portfolio assets consist "primarily" of "highly liquid investments," as well as "In-Kind ETFs,"[9] are not subject to the "highly liquid investment minimum" requirement.

- ***Role of the Board in Liquidity Management***. Under the Proposed Liquidity Rule, a fund's board would have been required to, among other things: (1) initially approve the fund's liquidity risk management program, including the TDLA Minimum; and (2) approve any material changes to a fund's liquidity risk management program, including any changes (material or otherwise) to the TDLA Minimum. Industry commenters opposed these requirements for several reasons, including a belief that the level of inquiry and expertise necessary to make these determinations would arguably require fund boards to move beyond their traditional oversight role and become actively involved in the day-to-day management of the fund. In response to these comments, the Commission modified the final Liquidity Rule, to not require a fund's board either to specifically approve the fund's highly liquid investment minimum (except in limited circumstances) or to approve material changes to the fund's liquidity risk management program.
- **Swing Pricing**. Under proposed amendments to Rule 22c-1 under the 1940 Act, funds (excluding money market funds and ETFs) would have been permitted, but not required, to use "swing pricing" to mitigate the risk that shareholder purchase and redemption activities could dilute the value of fund shares. Industry commenters expressed concern that swing pricing could create major operational challenges under the current market structure in the United States, despite the perception of the success of swing pricing in Europe described in the Proposing Release.

Requirements of the Liquidity Rule

Liquidity Risk Management Program

The Liquidity Rule requires funds, including In-Kind ETFs, to adopt and implement written liquidity risk management programs reasonably designed to assess and manage their liquidity risk. Each such program will be required to provide for the:

- Assessment, management and periodic review of liquidity risk;
- Classification and monthly review of the liquidity of portfolio investments; and
- Determination and periodic review, and procedures to address a shortfall, of a highly liquid investment minimum.

Assessment, Management and Review of Liquidity Risk

Funds, including In-Kind ETFs, must assess, manage and periodically review (no less frequently than annually) their "liquidity risk," taking into account certain specified factors. "Liquidity risk" is defined as "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."

The Commission's definition of "liquidity risk" indicates that liquidity risk management programs must address the potential dilution of remaining fund investors' interests caused by redemptions. The Liquidity Program Adopting Release noted that a "fund that chooses to sell its most liquid assets to meet fund redemptions may minimize the

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[9] An In-Kind ETF is an ETF that meets redemptions through in-kind transfers of securities, positions and assets other than a *de minimis* amount of cash, and which publishes its portfolio holdings daily.

effect of the redemptions on short-term fund performance for redeeming and remaining shareholders, but may leave remaining shareholders in a potentially less liquid and riskier fund until the fund adjusts the portfolio." Thus, assessing and managing liquidity risk would generally entail, among other things, addressing the way in which a fund's assets are sold if needed to meet shareholder redemption requests to seek to avoid potential significant dilution in value or a significant change in risk profile for remaining fund investors' interests.[10]

In assessing, managing and reviewing liquidity risk, funds must consider the following factors (Liquidity Risk Factors), as applicable:

- The fund's investment strategy and the liquidity of its portfolio assets during both normal and reasonably foreseeable stressed conditions, including whether the investment strategy "is appropriate for an open-end fund";[11]
- Short-term and long-term cash flow projections during both normal and reasonably foreseeable stressed conditions;[12]
- Holdings of cash and cash equivalents, as well as borrowing arrangements and other funding sources;[13] and
- For ETFs (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.[14]

Importantly, the Liquidity Program Adopting Release stated that the requirement to evaluate whether an investment strategy is appropriate for an open-end fund will likely cause funds to evaluate the suitability of investment strategies that will be permitted under the new 15% illiquid investment limit, but that could nonetheless present significant liquidity risk *(e.g.*, "strategies involving … investments that are so sensitive to stressed conditions that funds may not

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10 *See also* Liquidity Program Adopting Release, at Section II.E ("We anticipate that the new program requirement will result in investor protection benefits*, as improved liquidity risk management could decrease the chance that a fund could meet its redemption obligations only with significant dilution of remaining investors' interests or changes to the fund's risk profile."*) and n.164 ("When determining whether a fund's liquidity risk will cause significant dilution for purposes of this definition, 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."*) (emphasis added).

11 This assessment must also take into account the extent to which the fund's strategy involves a relatively concentrated portfolio, or large positions in particular issuers, and the use of borrowings for investment purposes and derivatives. The Liquidity Rule modified the wording of the proposal – changing "use of borrowings and derivatives for investment purposes" to "use of borrowings for investment purposes and derivatives" – in order "to clarify that funds should consider all derivatives, including those used for hedging purposes."

12 The Liquidity Program Adopting Release noted that the Proposed Liquidity Rule's five separate sub-considerations relevant to this factor have been eliminated from the rule text. Instead, they are included in the Liquidity Program Adopting Release as guidance. These sub-considerations are: (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.

13 In assessing the effect of borrowings on liquidity risk, the Liquidity Program Adopting Release noted that funds should consider: (1) the terms of the credit facility; (2) whether the line of credit is a committed or uncommitted line of credit; and (3) the financial health of the institution(s) providing the credit facility.

14 *See* Rule 22e-4(b)(1)(i)(A) – (D).

be able to find purchasers for those investments during stressed periods”). Moreover, according to the Commission, “funds that have significant holdings of securities with extended settlement periods may face challenges operating as open-end funds and should take these holdings into account when determining whether the fund’s portfolio is appropriate for an open-end fund.” For example, according to the SEC, “primarily holding securities with extended settlement periods beyond seven days may not be appropriate for an open-end fund, as primarily having such extended settlement holdings may raise concerns with the fund’s ability to meet redemptions within seven days, particularly if the fund has not established adequate other sources of liquidity.” The Commission noted in several places that investments with long settlement periods, such as certain bank loans, warrant consideration under the Liquidity Rule.

Liquidity Classification of Fund Investments

The Liquidity Rule requires funds (except In-Kind ETFs) to classify the liquidity of their portfolio investments (including derivatives transactions) into one of four liquidity categories based on the number of days within which the fund determines that it reasonably expects an investment to be convertible to cash (or, for the “less-liquid” and “illiquid” categories, sold or disposed of), without significantly changing the market value of the investment.

Liquidity Categories. The liquidity of fund portfolio investments must be classified in one of four categories: (1) highly liquid; (2) moderately liquid; (3) less liquid; or (4) illiquid.

- Highly liquid investments are cash and any investment reasonably expected to be “convertible to cash”[15] in current market conditions in three business days or less without significantly changing the market value of the investment.
- Moderately liquid investments are any investments reasonably expected to be convertible to cash in current market conditions in more than three calendar days but no more than seven calendar days without significantly changing the market value of the investment.[16]
- Less liquid investments are any investments reasonably expected to be able to be sold or disposed of in current market conditions in seven calendar days or less without 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.[17]
- Illiquid investments are any investments *not* reasonably expected to be able to be sold or disposed of in current market conditions in seven calendar days or less without significantly changing the market value of the investment.

In the Liquidity Program Adopting Release, the Commission noted that the value impact standard (*i.e.*, the requirement to determine whether the sale or disposition of an investment will significantly change the market value of the investment) “does not require a fund to actually re-value or re-price the investment for classification purposes,

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15 The phrase “convertible to cash” means the ability to be sold, with the sale settled. *See* Rule 22e-4(a)(3).

16 The Commission expects this category to “be an important component of the Form N-PORT reporting obligations because it will provide the Commission with information regarding the portion of a fund’s portfolio that is not on the most liquid end of the spectrum, but still is sufficiently liquid to meet redemption requests within the statutory seven-day period without causing significant dilution.”

17 The Commission noted that, “[i]n the event of an extended settlement period, at some point, a fund may need to consider re-classifying” a less liquid investment as illiquid.

nor does the standard require the fund to incorporate general market movements in liquidity determinations or estimate market impact to a precise degree." The Commission also emphasized that the liquidity classification categories pertain to current market conditions rather than to predictions of how an investment may trade in stressed market conditions.

Classification Inputs. Classification of portfolio investments must be based on information obtained after "reasonable inquiry" and must take into account "relevant market, trading and investment-specific considerations." A fund may classify portfolio investments (including derivatives transactions) according to their asset class (rather than on an investment-by-investment basis). However, 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 the investment as compared with other fund holdings in that asset class, the fund is required to separately classify that investment. A fund is also required to determine whether trading different portions of a position in a particular investment or asset class, in sizes that the fund would reasonably anticipate trading, is reasonably expected to significantly affect the liquidity of the investment. If so, the fund must consider that determination when classifying the liquidity of the investment or asset class. For derivatives transactions classified as anything other than highly liquid investments, a fund must identify the percentage of the fund's highly liquid investments that are segregated to cover, or pledged to satisfy margin requirements in connection with, those derivatives transactions in each classification category other than highly liquid. These requirements are discussed in more detail below.

Market, Trading and Investment-Specific Considerations. In adopting the Liquidity Rule, the Commission adopted "a principles-based requirement that a fund take into account relevant market, trading, and investment-specific considerations in classifying its portfolio investments" rather than, as originally proposed, a framework with mandatory consideration of several specified factors. The Commission did, however, include guidance on these factors in the Liquidity Program Adopting Release, viewing them as useful and relevant as part of the general market, trading and investment-specific considerations required of funds (including with respect to asset classes). The factors are:

- Existence of an active market for an asset class or investment, and the exchange-traded nature of an asset class or investment;[18]
- Frequency of trades or quotes, average daily trading volume;[19]
- Volatility of trading prices;[20]

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18 Notably, the Commission addressed investments by funds in ETF shares, stating that, "[w]hile we appreciate that ETFs' exchange-traded nature could make these instruments useful to funds in managing purchases and redemptions in certain circumstances … funds should consider the extent to which relying substantially on ETFs to manage liquidity risk is appropriate.… We … encourage 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.

19 The Commission noted: "In evaluating the frequency of trades (and bid and ask quotes) for an asset class or investment, a fund may wish to generally consider, among other relevant factors, the number of dealers quoting prices for that asset class or investment, the number of other potential purchasers and sellers, and dealer undertakings to make a market in the asset class or investment." Additionally, "the consideration of trading volume as a liquidity indicator should not by itself imply that low trading volume necessarily indicates low liquidity.… Analysis of capital structure and credit quality of a particular asset class or investment, as well as bid-ask spreads and maturity/date of issue, may be particularly useful in considering the liquidity of investments whose trading volume is normally low."

20 The Commission believes that, "[i]n general, there is an inverse relationship between liquidity and volatility."

- Bid-ask spreads;[21]
- Standardization and simplicity of an asset class's or investment's structure;[22]
- For fixed income securities, maturity and date of issue;[23] and
- Restrictions on trading and limitations on transfer.[24]

Liquidity Determinations on an Asset Class Basis. Under the Liquidity Rule, funds are permitted to classify the liquidity of portfolio investments according to asset class. However, funds must separately classify any investment if the fund or its adviser, after reasonable inquiry, has information about any market, trading or investment-specific considerations that are reasonably expected to significantly affect the liquidity characteristics of the investment as compared to the fund's other portfolio holdings within the same asset class. According to the Liquidity Program Adopting Release, examples of such information include knowledge that: (1) a large-capitalization equity security was affected by adverse events impacting the security's issuer;[25] and (2) certain high-quality corporate bonds' bid-ask spreads were significantly wider or more volatile than those of their peers. Additionally, the Liquidity Program Adopting Release stated that certain asset classes are expected to have a wide range of liquidity characteristics and that, therefore, a fund cannot reasonably determine to classify all investments within that asset class in a uniform manner.[26]

According to the Liquidity Program Adopting Release, procedures for classifying investments' liquidity by asset class "should incorporate sufficient detail to meaningfully distinguish between asset classes and sub-classes." In this regard, the Liquidity Program Adopting Release noted that: (1) fixed income securities could be distinguished based on issuer type, the market(s) in which the issuer is based, seniority, age and credit quality; (2) structured products could be distinguished based on tranche seniority and credit quality; and (3) equity securities could be distinguished based on the market(s) in which the security's issuer is based, market capitalization and whether the security is

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[21] In the Commission's view, "[i]n general, high bid-ask spreads for a particular asset class or investment correlate with a lack of liquidity in that asset class or investment."

[22] Similar to the Proposing Release, the Liquidity Program Adopting Release noted that "corporate bond issuers commonly have large numbers of bonds outstanding, and trading can be fragmented among that universe of bonds." However, the Liquidity Program Adopting Release noted that "standardization alone may not be indicative of an investment's liquidity," as, for example, "market participants may consider many corporate bonds to be highly comparable and substitutable from a liquidity perspective, to the extent that they share common characteristics such as issuer, sector, credit quality, and maturity."

[23] The Commission stated the belief that, "[i]n general, a fixed income asset trades most frequently in the time directly following issuance, and its trading volume decreases in the asset's remaining time to maturity … [and] high[er] trading volume generally suggests relatively high[er] liquidity." This suggests an assumption on the part of the Commission that, all else being equal, a fixed income asset's liquidity generally decreases over time.

[24] In the Commission's view, "restrictions on trading [and] limitations on an investment's transfer … may adversely affect those investments' liquidity." See Liquidity Program Adopting Release, at Section III.C.4.g (citing the discussion of contractual limitations on transfer in Stephen H. Bier, Julien Bourgeois & Joseph McClain, Mutual Funds and Loan Investments, *The Investment Lawyer* (Mar. 2015), at 2).

[25] The Liquidity Program Adopting Release did not provide clarity or guidance on the types of "adverse events" that would require a fund to separately classify any equity investment. Given the number of events that could potentially be deemed to be "adverse," funds may wish consider quantitative data, such as a material price decrease relative to a benchmark.

[26] The Liquidity Program Adopting Release cited to asset classes "encompassing some bespoke complex derivatives or complex structured securities" as examples of asset classes that have "a [wide] range of liquidity characteristics that each position would need to be classified individually."

common or preferred. According to the SEC, general categories, such as "equities" or "fixed income," are not appropriate. Procedures for classifying investments' liquidity by asset class should also include procedures (which the Liquidity Program Adopting Release refers to as "exception processes") for updating default classifications based on market, trading and investment-specific considerations. According to the Liquidity Program Adopting Release, exception processes should specify the sources of inputs (*e.g.*, inputs from portfolio management, risk management and/or trading) and particular variables (*e.g.*, relatively wider/narrower/more volatile bid-ask spreads compared with other assets in the asset class) that could impact classification. Exception processes may also incorporate an assessment of the liquidity classification factors, which are discussed above.

Market Depth Considerations. Under the Liquidity Rule, funds must determine whether trading different 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 the liquidity of the investment or asset class and, if so, this determination must be taken into account when classifying the liquidity of that investment or asset class.[27]

The Liquidity Rule does not appear to permit liquidity classifications of *portions* of portfolio assets. Indeed, the Commission stated that if a "fund determined, after conducting the required market depth analysis, that a downward adjustment in the liquidity classification of a particular investment is appropriate, 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*)." (emphasis added)

Although the Commission stated that this approach "is meant to lessen burdens on funds," it may also increase the complexity and risk associated with liquidity classification. For example, a fund may hold a large position but anticipate trading only moderately-sized blocks of the position regularly, and because of significant market depth, the fund may determine that this trading is not reasonably expected to significantly affect the portfolio investment's liquidity. If circumstances change and market depth suddenly decreases – for instance, a major market participant withdraws from the market – the fund may then determine that its anticipated trading is reasonably expected to significantly affect the portfolio investment's liquidity and, as a result, a downward adjustment in the liquidity classification may be necessary, and it would apply to the entire position despite the expectation of trading only moderately-sized blocks. If the position were initially classified as less liquid, and the downward adjustment would result in the entire position being classified as illiquid, the fund might unexpectedly be in danger of exceeding the 15% limit for illiquid investments.

Classification and Derivatives. The Liquidity Rule requires that a fund identify the percentage of its highly liquid investments that are segregated to cover, or pledged to satisfy margin requirements in connection with, its derivatives transactions classified as moderately liquid, less liquid or illiquid. This percentage will be disclosed on Form N-PORT and, as discussed below, must be excluded when determining whether a fund primarily holds assets that are highly liquid investments (for purposes of determining whether the highly liquid investment minimum provisions of the Liquidity Rule are applicable).

The requirements regarding highly liquid investments used for cover or pledged to satisfy margin requirements replace the proposed requirement to consider the relationship of the asset being classified to another portfolio asset, as well as the associated guidance that a fund should classify the liquidity of segregated assets according to the

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27 *See* Liquidity Program Adopting Release, at Section III.C.2.d, 3.a ("To the extent that the fund determines that trading varying portions of a position is reasonably expected to significantly affect the liquidity characteristics of that investment – *that is, 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 investment's liquidity) (emphasis added).

liquidity of the derivative instruments they are covering. Such guidance likely would have represented a significant change in current segregation practice for many funds.[28] Instead, under the approach taken by the Liquidity Rule, funds generally need not specifically identify particular assets segregated or pledged to cover derivatives transactions.

Review of Liquidity Classifications. Under the Liquidity Rule, a fund must review its portfolio investments' classifications at least monthly in connection with required Form N-PORT classification reporting, and more frequently if changes in relevant market, trading and investment-specific considerations are reasonably expected to materially affect one or more of its investments' classifications.

The Liquidity Program Adopting Release provided several examples of market-wide and asset-class and investment-specific developments that may be relevant in determining whether to review liquidity classifications: (1) changes in interest rates or other macroeconomic events; (2) market-wide volatility; (3) market-wide flow changes; (4) dealer inventory or capacity changes; (5) natural disasters; (6) political upheaval; (7) regulatory changes affecting certain asset classes; and (8) corporate events *(e.g.,* bankruptcy, default, pending restructuring, delisting and reputational events).

Highly Liquid Investment Minimum

Under the Liquidity Rule, funds (except In-Kind ETFs) that do not "primarily" hold assets that are highly liquid investments must: (1) determine a highly liquid investment minimum (HLIM) considering the Liquidity Risk Factors (discussed above); (2) periodically review, no less frequently than annually, the HLIM; and (3) adopt policies and procedures for responding to a "shortfall" of the HLIM (Shortfall Policies and Procedures). The HLIM requirement does not prohibit a fund from acquiring assets other than highly liquid investments during an HLIM Shortfall (as defined below). The HLIM may not be changed during any period where the percentage of the fund's assets that are highly liquid investments is below the HLIM (such event, an HLIM Shortfall) without approval of the fund's board, including a majority of the independent board members. Otherwise, a fund's board is not ordinarily required to specifically approve the HLIM.

Although not required under the Liquidity Rule, the Commission stated that a fund should consider adjusting its HLIM if the fund encounters extremely stressed market conditions that could increase its liquidity risk to unusual levels, and a fund should review its HLIM more frequently than annually if circumstances warrant. More generally, and consistent with the Proposed Liquidity Rule, the Commission stated that it would be "extremely difficult" to conclude that a HLIM of zero would be appropriate.

Consideration of Liquidity Risk Factors. A fund must consider the Liquidity Risk Factors when determining its HLIM, but only as they apply during normal conditions and during stressed conditions reasonably foreseeable during

[28] *See id.*, at n.470 and accompanying text (citing the Dechert Comment letter, and stating that commenters explained that the proposed guidance "would be unworkable and would raise costly operational burdens, because funds currently do not identify individual liquid assets to cover specific derivatives transactions. Instead, … it is common in the fund industry for a fund to review its outstanding obligations under its derivatives positions on a portfolio basis and determine an aggregate amount of liquid assets that must be segregated in connection with the transactions requiring coverage.").

the period until the next periodic review of the HLIM.[29] The Liquidity Program Adopting Release noted that the Commission's guidance regarding the Liquidity Risk Factors in assessing liquidity risk (as discussed above) is also appropriate in the context of determining the HLIM.

With respect to a fund's consideration of its investment strategy and the liquidity of portfolio assets, the Liquidity Program Adopting Release stated the Commission's belief that: (1) the less liquid the fund's portfolio investments, the higher the fund should establish its HLIM; (2) funds with strategies typically having greater volatility of flows (*e.g.*, alternative funds and emerging market debt funds) would generally require higher HLIMs; (3) funds with leveraged strategies generally need higher HLIMs; and (4) funds having or expecting to segregate significant amounts of highly liquid assets for cover purposes (or to pledge significant amounts of highly liquid assets for margin requirements) should consider that such segregated or pledged assets may not be available to meet redemptions when setting their HLIMs.

With respect to a fund's consideration of short-term and long-term cash flow projections, the Commission believes that, all else being equal, higher HLIMs may be warranted where a fund: (1) has a concentrated shareholder base such that redemption decisions by one or a small number of shareholders can require the fund to sell significant amounts of assets; (2) has a redemption policy to meet redemptions the next business day; (3) is sold through distribution channels that attract investors with more volatile or unpredictable flows; and (4) does not have substantial visibility into its shareholder base or is uncertain about changing market conditions likely to materially affect net redemptions.

With respect to a fund's holding of cash and cash equivalents, such holdings, as well as access to a line of credit or other funding source to meet redemptions, provide flexibility as to liquidity risk management and may indicate decreased liquidity risk, which may be considered when setting the HLIM.

Highly Liquid Investment Minimum Shortfall Policies and Procedures. Under the Liquidity Rule, a fund's Shortfall Policies and Procedures must require that the Program Administrator (as defined below): (1) report to the fund's board, no later than its next regularly scheduled meeting, with a brief explanation of the causes and extent of any HLIM Shortfall, as well as any actions taken in response; and (2) if the HLIM Shortfall lasts more than seven consecutive calendar days, report to the fund's board within one business day, with an explanation of how the fund plans to restore its HLIM within a reasonable period of time. Any HLIM Shortfall that lasts for more than seven consecutive calendar days must also be reported to the SEC on new Form N-LIQUID.

In the Liquidity Program Adopting Release, the Commission recognized the difficulty in specifying in advance all appropriate factors and approaches for addressing an HLIM Shortfall, and that the process would involve evaluation of the particular circumstances surrounding an HLIM Shortfall. However, the Commission went on to suggest that Shortfall Policies and Procedures should specify some of the actions the fund could consider taking to respond to an HLIM Shortfall under different conditions and specify market- and fund-specific circumstances that could shape the response to an HLIM Shortfall. The Commission also stated that a fund should consider modification to its Shortfall Policies and Procedures where the fund regularly encounters HLIM Shortfalls.

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[29] Formally, this limitation is with reference only to the first two Liquidity Risk Factors: (1) the investment strategy and liquidity of portfolio assets (including assessment of 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); and (2) short-term and long-term cash flow projections.

Review of Highly Liquid Investment Minimum. The Liquidity Rule requires that the HLIM be reviewed no less frequently than annually. This requirement was adopted primarily to correlate with the minimum period in which a fund's board would be required to review the written report of the Program Administrator (as discussed below). The Commission suggested that funds may wish to adopt procedures specifying circumstances that would prompt, and the process for conducting, more frequent reviews of the HLIM.

Exclusion for Funds "Primarily" Holding Assets that are Highly Liquid Investments. Under the Liquidity Rule, funds that "primarily" hold assets that are highly liquid investments (Primarily Highly Liquid Funds) are not subject to the HLIM requirements. The Commission expects that Primarily Highly Liquid Funds will address in their liquidity risk management programs how the funds determined that they are Primarily Highly Liquid Funds, such as by defining "primarily" in this context. Although the Commission did not formally define what it means to be a Primarily Highly Liquid Fund, the Liquidity Program Adopting Release did provide guidance, stating that "[i]n our view, if a fund held less than 50% of its assets in highly liquid investments it would be unlikely to qualify as 'primarily' holding assets that are highly liquid investments."[30] The Commission noted that, due to portfolio drift or changes in investment strategies, a fund may cease to be a Primarily Highly Liquid Fund, and thus become subject to the HLIM requirements.

Importantly, for purposes of determining whether a fund is a Primarily Highly Liquid Fund, the fund must exclude from its calculations the percentage of fund assets that are highly liquid investments segregated to cover, or pledged to satisfy margin requirements in connection with, derivatives transactions classified as moderately liquid, less liquid and illiquid investments.

15% Limit on Illiquid Investments

The Liquidity Rule prohibits the acquisition by a fund (including an In-Kind ETF) of 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."[31] The Liquidity Rule effectively codifies in a 1940 Act rule the Commission's historical limit on investments in illiquid assets and supersedes previous SEC guidance regarding illiquid investment limits; this could have an important impact on funds.[32]

Under the Liquidity Rule, an "illiquid investment" is defined 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

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30 This footnote also states that "a highly liquid index fund would be one example of a fund whose portfolio consists primarily (in the case of these index funds, almost entirely) of assets that are highly liquid investments." The index funds referenced appear to be index funds that seek to track the performance of indices that are comprised of highly liquid assets.

31 Rule 22e-4(b)(1)(iv) specifically refers to investments that are "assets," in order to clarify that the limitation on illiquid investments applies to investments with positive values, and that the limitation does not permit netting illiquid investments with negative values against illiquid investments with positive values.

32 The Liquidity Program Adopting Release indicated that the Commission is withdrawing existing guidance contained in the following releases regarding the 15% limit on illiquid investments, as well as guidance regarding the process for determining the liquidity of an asset: Revisions of Guidelines to Form N-1A, Investment Company Act Rel. No. 18612 (Mar. 12, 1992); Resale of Restricted Securities; Changes to Method of Determining Holding Period of Restricted Securities Under Rules 144 and 145, Investment Company Act Rel. No. 17452 (Apr. 23, 1990); and Statement Regarding "Restricted Securities," Investment Company Act Rel. No. 5847 (Oct. 21, 1969).

disposition significantly changing the market value of the investment.[33] In addition, as discussed above, the Liquidity Rule requires a fund to consider relevant market, trading and investment-specific considerations, as well as market depth, when classifying a fund's investments as illiquid investments for purposes of both the general classification framework described above as well as for purposes of the 15% limit. For example, under the Liquidity Rule, a fund must determine whether trading varying portions of a position in a particular investment, in sizes that the fund would reasonably anticipate trading, is reasonably expected to significantly affect the liquidity of that investment. If so, the fund must take this determination into account when classifying the liquidity of that investment. The SEC acknowledged that, because of this change, "some funds may determine that a greater percentage of holdings are illiquid."

If a fund's portfolio includes illiquid investments in excess of the 15% limit, the fund may not acquire additional illiquid investments. In response to concerns from industry participants regarding the unintended consequences from the sale of illiquid investments at undesirable discounts, the Liquidity Rule will *not* require a fund to divest illiquid investments if the fund's holdings of illiquid investments exceed the 15% limit. However, the Commission stated its belief that "a fund should not be permitted to exceed the 15% limit on illiquid investments for an extended period of time without board oversight," and, therefore, exceeding the 15% limit will trigger the following disclosure and board reporting obligations: (1) the fund must confidentially report to the Commission within one business day on Form N-LIQUID that the fund's portfolio exceeds the 15% limit; and (2) the Program Administrator must report such occurrence to the fund's board within one business day, explaining the extent and causes of the occurrence, as well as providing a proposed plan to bring illiquid investments to or below the 15% limit "within a reasonable amount of time."[34] Furthermore, if, after 30 days (and each 30-day period thereafter), the percentage of a fund's net assets in illiquid investments continues to exceed the 15% limit, the fund's board (including a majority of independent board members) is required to assess whether the plan to bring illiquid investments to or below the 15% limit continues to be in the fund's best interest.[35]

Board Oversight

In connection with the requirement that each fund establish a liquidity risk management program, the Liquidity Rule imposes new oversight responsibilities on a fund's board, including: (1) initially approving the fund's written program; (2) approving the designation of the person, or a group of persons, responsible for administering the program (Program Administrator); and (3) reviewing (at least annually) a written report prepared by the Program Administrator. In addition, as discussed below, the board has certain non-recurring oversight responsibilities with respect to a fund's HLIM and investments in illiquid investments.

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33 Accordingly, the Commission harmonized its codification of the 15% limit with the general classification framework described above (*i.e.,* the same definition of "illiquid investment" is used for purposes of both the general classification framework as well as for purposes of the 15% limit). By contrast, the Proposed Liquidity Rule would have required a fund to use a separate standard for classifying the fund's assets for purposes of the 15% limit.

34 The SEC anticipates that, if a fund exceeds the 15% limit at any time during the year, the written report to the board regarding the adequacy and effectiveness of the fund's liquidity risk management program would discuss the breach. If a fund continues to breach the 15% limit at the time of the report, the report must also discuss the plan to bring the fund's illiquid investments to or below the 15% limit within a reasonable period of time.

35 As a result, board members may need to either meet telephonically or in-person whenever a fund's net assets invested in illiquid investments exceed the 15% limit for more than 30 days.

Importantly, despite these new responsibilities and in response to commenters, the Commission confirmed that the board's role is one of general oversight, and that board members should exercise their reasonable business judgment to oversee the "adequacy and effectiveness" of a fund's liquidity risk management program.[36] The SEC noted that increased board involvement is intended to protect investors by ensuring that redemption requests can be satisfied without diluting remaining investors. However, despite requests by the fund industry for the SEC to adopt an express standard of care to which the board would be held accountable, the Commission noted that the board oversight role in the context of administering the liquidity risk management program is similar to its role/responsibilities in other contexts governed by the 1940 Act, making a specific standard unnecessary.

Approving the Program Administrator. Under the Liquidity Rule, the board (including a majority of independent board members) is responsible for approving the designation of the fund's Program Administrator. A fund's Program Administrator could be the fund's investment adviser or sub-adviser, a specific fund officer or a group of fund officers. Although portfolio managers may comprise part of a committee or group approved as the Program Administrator, to ensure a sufficient level of separation between a fund's portfolio management and risk management, the Program Administrator function cannot be assigned solely to portfolio managers. The Commission noted that this requirement is intended to balance the need for independent assessment of liquidity risk with management expertise. A fund may also delegate administration of a part of its program to third-party service providers, subject to appropriate oversight by the fund.

According to the Commission, "a fund generally should consider the extent of influence portfolio managers may have on administration of the program, and seek to provide independent voices and administration of the program as a check on any potential conflicts of interest to the extent appropriate." Nonetheless, the SEC noted that a fund's Program Administrator "might wish to consult with the fund's portfolio manager, traders, risk managers and others as necessary or appropriate in administering a fund's liquidity risk management program." This consultation may be necessary for liquidity risk management programs that, for example, rely on sophisticated models.

Approving the Liquidity Risk Management Program. The board (including a majority of independent board members) must initially approve a fund's written liquidity risk management program. In doing so, the board may rely on summaries of the program provided by the Program Administrator, legal counsel or others with knowledge of how the program would be administered. The summary should educate the board as to the "salient features" of the program and help the board members understand how the program would address a fund's liquidity risk.

Reviewing the Annual Report. The board (including a majority of independent board members) must also review a written report, to be provided by the Program Administrator no less frequently than annually, which details the operation of a fund's liquidity risk management program. To assist the board in evaluating the adequacy and effectiveness of the program, the report should also include a description of:

- The operation of the fund's HLIM over the past year, if applicable;
- Any occurrences throughout the year when the fund has exceeded the 15% limit on illiquid investments; and

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[36] *See also* Mary Jo White, Chair, Securities and Exchange Commission, The Fund Director in 2016: Keynote Address at the Mutual Fund Directors Forum 2016 Policy Conference, (Mar. 29, 2016) (recognizing board members' oversight role, rather than day-to-day management role, but still encouraging board members to consider the quality of liquidity information received from management, the link between liquidity and valuation and whether certain funds pursue strategies that are more likely to face liquidity challenges).

- Any material changes to the program.

The Commission noted that, under certain circumstances, a fund may decide that liquidity risk needs to be reviewed more frequently than annually. This determination could be made based on market and/or sector-wide developments, changes to a fund's operations or other fund-specific circumstances. Under the proposal, the Commission would have also required a fund's board to approve material changes to a fund's liquidity risk management program. However, in response to commenters,[37] the Commission instead decided to allow the board to review material changes as contained in the annual report, in a manner consistent with the current framework under Rule 38a-1 under the 1940 Act.

Incident-Driven Board Reporting. In addition to the standard review and approval responsibilities outlined above, the board has certain additional responsibilities for overseeing compliance with the HLIM and illiquid investments limit.

Highly Liquid Investment Minimum. In situations where the Program Administrator seeks to make a change to a fund's HLIM at a time when the fund's portfolio is below the pre-established minimum, the board (including a majority of independent board members) is required to approve such change. This represents a modification to the proposal, which would have required the board to approve a fund's TDLA Minimum and any changes thereto. While the Liquidity Rule is less onerous than the proposal on this point, the Commission noted that board oversight of some sort is necessary to ensure that the HLIM serves as a risk management tool.

Further, a fund's board is responsible for reviewing additional reports pursuant to the fund's Shortfall Policies and Procedures. If at any time a fund's investments fall below the fund's HLIM, the board must receive a report of the occurrence at the next scheduled board meeting. This requirement would permit fund management to provide the board with a single report if a fund drops below its HLIM multiple times between scheduled board meetings. However, should a fund's investments fall below its HLIM for more than seven consecutive days, the Program Administrator must report to the board within one business day.

Illiquid Investments. The Program Administrator must provide the board with a report within one business day if a fund's illiquid investments exceed the 15% limit on illiquid investments. In the report, the Program Administrator must explain the cause and extent of the fund exceeding the 15% limit, as well as provide a plan to bring the percentage of the fund's assets in illiquid investments back in compliance with the 15% limit. As discussed above, the board has additional responsibilities if a fund's illiquid investments remain above the 15% limit for more than 30 consecutive days (and each 30-day period thereafter).

In-Kind Redemption Procedures

Currently, many funds reserve the right to satisfy a redeeming shareholder's interest in a fund by distributing a portion of the fund's portfolio securities rather than cash.[38] These so-called "in-kind" redemptions allocate the transaction costs of liquidating portfolio securities to the redeeming shareholder instead of the remaining shareholders. Under the Liquidity Rule, funds that engage in, or reserve the right to engage in, in-kind redemptions, including In-Kind ETFs,

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[37] *See* Liquidity Program Adopting Release, at n. 824 (citing Dechert Comment Letter).

[38] Pursuant to Rule 18f-1 under the 1940 Act, a fund is permitted to make an election with the SEC in order to satisfy redemption requests with cash for any request during any 90-day period of up to the lesser of $250,000 or 1% of the fund's NAV at the beginning of the period.

are required to establish policies and procedures that address the process for and the circumstances under which they may engage in in-kind redemptions.[39]

According to the Commission, effective and well-designed in-kind redemption policies and procedures should contemplate, among other things: (1) the particular types of events or conditions (*e.g.*, stressed market conditions) that would cause a fund to engage in in-kind redemptions; (2) whether in-kind redemptions would be used only for requests over a certain size; (3) the ability of shareholders to receive in-kind redemptions;[40] (4) whether holdings through omnibus accounts pose any unique issues; (5) other potential operational issues, which may include implementing in advance a securities transfer process with certain large shareholders; and (6) whether portfolio securities would be distributed on a *pro rata* or a non-*pro rata* basis.[41]

Guidance on Cross-Trades

The Liquidity Program Adopting Release provided guidance on the use of cross-trades, but did not explicitly amend Rule 17a-7 under the 1940 Act, which is the exemptive rule pursuant to which cross-trades are effected between funds and certain affiliates. In the Proposing Release, the SEC stated its view that certain requirements under Rule 17a-7, including the requirements that market quotations for a security which is the subject of a cross-trade must be readily available and the transaction must be effected at the independent "current market price," may be less likely to be satisfied where the security in question is less liquid. The Commission also noted that less-liquid assets may be ineligible to trade under Rule 17a-7. While the Commission recognized that a security's liquidity, taken alone, is not determinative of its eligibility under Rule 17a-7, the Liquidity Program Adopting Release also noted that it may be more difficult to determine that the terms of a cross-trade are fair and reasonable when less-liquid assets are involved. In connection with this observation, the SEC 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" cross-trading less-liquid assets.

The Commission also noted that a fund's compliance policies and procedures (as required under Rule 38a-1) generally should contemplate how the fund would satisfy the terms and conditions of Rule 17a-7 with respect to less-liquid assets, including ensuring (among other things) that: (1) market quotations are readily available; and (2) the

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39 Many ETFs (including In-Kind ETFs) are subject to various requirements under their exemptive relief with respect to how they effect in-kind redemptions, including the composition of the basket of securities to be distributed in an in-kind redemption. ETFs' in-kind redemption procedures required under the Liquidity Rule should be consistent with the requirements under the ETF's exemptive relief.

40 According to the Liquidity Program Adopting Release, the policies and procedures, for example, "might provide that retail shareholders (who may not be operationally equipped to receive in-kind redemptions) may be provided cash redemptions, but that institutional investors who may be able to receive such securities, would be paid out in-kind under certain circumstances."

41 According to the Liquidity Program Adopting Release, if a fund provides for in-kind redemptions on a non-*pro rata* basis, effective policies and procedures should contemplate whether the selection, valuation and distribution of portfolio securities are fair both to redeeming and remaining shareholders, which consideration may include an assessment of tax consequences for shareholders. These policies and procedures should also address odd lots, illiquid securities or securities that have transfer restrictions.

availability of a "current market price."[42] In addition, the Commission suggested that funds consider: (1) specifying in their policies and procedures "the sources of the readily available market quotations to be used to value the assets"; (2) establishing specific criteria for determining whether market quotations are current and readily available and continue to be appropriate (and including potential back-up sources if the primary sources of quotations are not available); and (3) establishing a mechanism for assessing the quality of quotations provided by dealers. According to the Commission, the quality of dealer quotes may vary depending on whether the applicable dealer makes a market in, or maintains an inventory of, the applicable security (on the basis that the dealer would be aware of market factors affecting the value of the security). The Commission also noted that "'[i]ndications 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."[43]

Treatment of Exchange-Traded Funds under the Liquidity Rule

In the Liquidity Program Adopting Release, the Commission agreed with commenters that various characteristics of ETFs necessitate a different approach to assessing liquidity risks, including: (1) the role of authorized participants in the creation and redemption process; (2) the use by many ETFs of in-kind transfers for purchases and redemptions in place of cash; and (3) the exchange-traded nature of ETF shares.[44] While the Liquidity Rule does not exempt ETFs, the SEC adopted a tailored approach for ETFs to utilize when implementing a liquidity risk management program.[45] The Commission justified requiring ETFs to assess and manage liquidity risk in a manner similar to other open-end funds, even in the case of In-Kind ETFs (which do not need to sell portfolio securities to satisfy redemptions), by stating that illiquidity of an ETF's underlying portfolio securities could result in widening of ETF shares' bid-ask spread or result in market prices that differ materially from the NAV of ETF shares. Furthermore, the Commission stated that portfolio illiquidity could impact a market maker's ability or willingness to engage in the arbitrage function. As part of the tailored approach for ETFs, the Commission has codified a classification known as an "In-Kind ETF," which is an ETF that meets redemptions through in-kind transfers of securities, positions and assets other than a *de minimis* amount of cash, and which publishes its portfolio holdings daily. ETFs that comply with the definition of an In-Kind ETF are exempt from the Liquidity Rule's requirements related to portfolio liquidity classifications and the HLIM.

Applicable Requirements for All ETFs. Under the Liquidity Rule, ETFs will be required to adopt a liquidity risk management program. However, ETFs will be required to consider two additional factors when assessing their liquidity risks. First, ETFs will need to assess the relationship between an ETF's liquidity and the manner in which its

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42 *See* Liquidity Program Adopting Release, at Section III.F ("Reasonably designed policies and procedures thus 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.")

43 *See id.,* at n.800 (cautioning that "[d]ealers do not necessarily purport to provide quotations for securities that reflect their current market values" and distinguishing "indications of interest" and "accommodation quotes" from "bids" and "offers.")

44 In addition to comments received on the Proposed Liquidity Rule, the SEC noted that it also considered comments received in response to the Commission's 2015 request for public comment on the listing and trading of exchange-traded investment products. The Commission emphasized the period of market volatility on August 24, 2015 as an example of the unique ETF market and the necessity for regulation regarding liquidity risks.

45 The Commission noted that ETFs will be subject to the general requirements of implementing an overall liquidity risk management program, including the obligation to determine whether the fund's investment strategy is appropriate for an open-end fund.

shares trade, including an analysis of bid-ask spread, the efficiency of the arbitrage process, and the level of engagement by market participants. As described in the Liquidity Program Adopting Release, in the event that the arbitrage function is impacted due to liquidity concerns, an ETF's share price may not correlate with its NAV, which could adversely impact certain shareholders transacting in the market.

Second, an ETF must evaluate the composition of its basket of securities and the effect of that basket on the ETF's liquidity. The SEC asserted that if the securities in the basket are not a *pro rata* share of the ETF's portfolio, this could impact the overall liquidity profile of the fund. In the Liquidity Program Adopting Release, the Commission provided an example in which the redemption basket includes a higher percentage of liquid investments than the ETF's portfolio as a whole; as a result, the ETF's remaining portfolio may be less liquid following the transaction; this can affect the authorized participants' ability to transact in the fund going forward and may result in shareholder dilution. Conversely, should the redemption basket include a higher percentage of illiquid investments, the liquidity costs imposed on the authorized participants may increase, which could ultimately impact investors since the ETF's bid-ask spread may increase.

In addition, as part of new annual reporting obligations on Form N-CEN, an ETF (including an In-Kind ETF) will be required to report "the average percentage value of creation units purchased and redeemed both with in-kind securities and assets and with cash, during the reporting period."

Considerations Specific to In-Kind ETFs. The Liquidity Rule exempts In-Kind ETFs from the portfolio liquidity classification requirement and the HLIM requirement.[46] To qualify as an In-Kind ETF, an ETF must limit its redemption basket to in-kind securities and other assets, and no more than a *de minimis* amount of cash. Because the In-Kind ETF definition applies to the redemption basket, compliance with this definition requires ongoing monitoring of the amount of cash used to settle each redemption transaction. In this regard, the Liquidity Program Adopting Release indicated that an ETF that delivers all cash to a single authorized participant that elects to receive cash, would not qualify as an In-Kind ETF, even though it normally redeems in kind. In addition, there is an obligation to provide daily transparency of a fund's holdings.[47]

An In-Kind ETF is required to describe in its written policies and procedures (as described further below) the amount of cash and the types of transactions it will treat as *de minimis*. The Liquidity Program Adopting Release cited the following as non-exclusive examples of when an ETF may use cash to satisfy redemption requests:

- Using cash as a "balancing amount" to make up any difference between the NAV of a creation unit and the market value of the aggregate basket of securities (the Liquidity Program Adopting Release indicated that, by its nature, the balancing amount would be *de minimis*);
- Using cash as part of a redemption basket to correspond to the amount of cash held by the ETF (this cash amount would be deemed an in-kind redemption); and

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46 Although In-Kind ETFs are exempt from the Liquidity Rule's liquidity classification requirements, In-Kind ETFs are nevertheless subject to the 15% limit on illiquid investments. Consequently, an In-Kind ETF continues to still be required to classify which of its net assets fall within the fourth category of the liquidity classification – an "illiquid investment" – for purposes of the 15% limit.

47 As a practical effect of adopting the Liquidity Rule, the Commission is codifying a condition (*i.e.*, full portfolio transparency) of many exemptive orders received by ETF issuers; this operational obligation will be required of ETF issuers that are not currently subject to this condition in their respective exemptive orders, in order for such ETFs to qualify as In-Kind ETFs.

- Using cash when a portfolio instrument is not eligible for in-kind transfer.[48]

The SEC acknowledges that there may be other reasons why an ETF may use cash to meet redemptions. The Liquidity Program Adopting Release, however, emphasized that if an ETF uses cash for any reason to satisfy redemption requests in excess of a *de minimis* amount (as determined in accordance with the ETF's written policies and procedures), it would not qualify as an In-Kind ETF.

According to the Liquidity Program Adopting Release, an In-Kind ETF "generally should describe in its written policies and procedures for its liquidity risk management program, to the extent applicable, how the fund analyzes the ability of the ETF to redeem in-kind in all market conditions such that it is unlikely to suddenly fail to continue to qualify for this exception to the classification and highly liquid investment minimum requirements, the circumstances in which the In-Kind ETF may use a *de minimis* amount of cash to meet a redemption, and what amount of cash would qualify as such." In addition, according to the Liquidity Program Adopting Release, "an In-Kind ETF generally should also describe how the ETF will manage and/or approve any portion of a redemption that is paid in cash and document the ETF's determination that such a cash amount is *de minimis*."[49] A fund must report its classification as an In-Kind ETF annually on Form N-CEN.

Limitation on Redemption Transaction Fees. The Commission declined in the Liquidity Program Adopting Release to address the point made by numerous commenters[50] that increasing or eliminating the two percent limitation on redemption transaction fees would enhance liquidity of ETFs and encourage more efficiency in the arbitrage process.[51] While such analysis may have been appropriately considered in connection with swing pricing rules established for open-end funds, the Liquidity Program Adopting Release indicated that the Commission believed issues relating to ETF redemption transaction fees were beyond the scope of the Liquidity Rule.

Treatment of Unit Investment Trusts under the Liquidity Rule

Unit investment trusts (UITs) are not required to adopt a liquidity risk management program; however, the Liquidity Rule requires UITs to conduct a limited liquidity review. On or before a UIT's initial date of deposit, the UIT's principal underwriter or depositor must determine that the liquidity of the securities deposited into the UIT are consistent with the liquidity and redeemable characteristics of the securities the UIT will issue. The Commission indicated in the Liquidity Program Adopting Release that the expected analysis of a UIT issuer should resemble the process for determining whether a fund's holding of illiquid investments is consistent with the 15% limit on illiquid investments. This initial evaluation is consistent with the unmanaged structure of a UIT and comparable to an open-end fund's determination of whether such fund's strategy is appropriate for an open-end fund.

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[48] However, the SEC stated that "depending on the size of the position being substituted for, such a transaction may not always be *de minimis*, and thus the ETF may no longer be able to qualify" as an In-Kind ETF. *See* Liquidity Program Adopting Release, at n.852.

[49] According to the SEC, "an In-Kind ETF may consider, if applicable: (i) the amount (both in dollars and as a percentage of the entire redemption basket) and frequency with which cash is used to meet redemptions; and (ii) the circumstances and rationale for using cash to meet redemptions."

[50] *See* Dechert Comment Letter; Comment Letter of Investment Company Institute (Jan. 13, 2016).

[51] Commenters noted that the current two percent limitation on redemption transaction fees was inconsistent with the proposed rules for swing pricing, which had no upper limit. However, as discussed in further detail below, the Swing Pricing Amendments impose a two percent upper limit on the swing factor.

Swing Pricing

Under the Swing Pricing Amendments, funds (excluding money market funds and ETFs) would be permitted, but not required, to use swing pricing as part of their liquidity risk management programs in order to mitigate the risk that shareholder purchase and redemption activities could dilute the value of fund shares. Swing pricing refers to a mechanism that would adjust the NAV of a fund's shares to effectively pass on the costs associated with purchases or redemptions of fund shares to the purchasing or redeeming shareholders. Subject to certain modifications outlined below, the Swing Pricing Amendments were adopted substantially as proposed.

Before a fund can utilize swing pricing, it will be required to establish policies and procedures that, among other things, designate an amount (swing factor) by which the fund will adjust its NAV if the level of net purchases into or net redemptions from the fund exceed a predetermined percentage of the fund's NAV (swing threshold). In addition, the swing pricing policies and procedures will be required to: (1) specify the process for determining the swing threshold(s) and swing factor(s); and (2) provide for the board's review of periodic reports prepared by the persons responsible for administering swing pricing.

According to the Swing Pricing Adopting Release, there has been a trend towards the adoption of swing pricing in Europe by major market participants. The Commission has indicated that industry trade associations in France and Luxembourg have already adopted guidelines on swing pricing procedures. According to the SEC, the swing pricing policies adopted by the Swing Pricing Amendments are consistent with those used abroad.[52]

Swing Threshold. A fund's swing threshold is defined as "the amount of net purchases into or net redemptions from a fund, expressed as a percentage of the fund's net asset value, which triggers the initiation of swing pricing." In-kind purchases and redemptions would be excluded from this calculation. According to the Swing Pricing Adopting Release, a fund's swing threshold "should generally reflect the estimated point at which net purchases or net redemptions would trigger the fund's investment adviser to trade portfolio assets in the near term, to a degree or of a type that may generate material liquidity or transaction costs for the fund." To assist a fund in predicting the levels of purchases and redemptions that would cause the fund to incur material costs, the Swing Pricing Amendments would require the fund to consider, at a minimum, the following factors:

- The size, frequency and volatility of historical net purchases or net redemptions of fund shares during normal and stressed periods;
- The fund's investment strategy and the liquidity of the fund's portfolio assets;
- The fund's holdings of cash and cash equivalents, as well as borrowing arrangements and other funding sources; and
- The costs associated with transactions in the markets in which the fund invests.

In response to feedback from commenters, the Swing Pricing Amendments will permit a fund to establish multiple escalating swing thresholds, together with a corresponding swing factor associated with each threshold. The Commission noted that "permitting … multiple thresholds may allow funds to more precisely target the cost of managing shareholder activities and better mitigate shareholder dilution effects of such transactions."

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52 *See, e.g.,* Association of the Luxembourg Fund Industry, Swing Pricing Update 2015 (Dec. 2015) (ALFI Survey 2015), at 21, available here.

The determination of a fund's swing threshold must be made pursuant to policies and procedures approved by the fund's board (including a majority of independent board members). In addition, the fund's board will be required to periodically review a report prepared by the persons responsible for administering swing pricing, which describes (among other things) such persons' assessment of the fund's swing threshold(s). Any change to a fund's swing threshold(s) will require approval by the fund's board.

Swing Factor. Under the Swing Pricing Amendments, a fund's swing factor is defined as the "amount, expressed as a percentage of the fund's NAV, by which the fund adjusts its NAV when the fund's net purchases or net redemptions cross the fund's swing threshold." According to the Commission, this amount should reflect the estimated costs associated with purchase and redemption activity that could dilute the value of existing shareholders' interests in the fund.

The Swing Pricing Amendments require a fund's swing pricing policies and procedures to describe the process for determining the fund's swing factor. Based on concerns raised by commenters regarding the discretion of funds to set their swing factor, the Swing Pricing Amendments contain an explicit requirement that the swing factor be "reasonable in relationship to near-term costs." The Commission stated that "the term 'near-term costs' does not envision a precise number of days," and that, in context, this term would "not likely encompass costs that are significantly removed in time from the purchases or redemptions at issue." According to the SEC, determination of a fund's swing factor (and generally the administration of a fund's swing pricing policies and procedures) must be reasonably separated from portfolio management of the fund and "may not include portfolio managers." The Commission believes that segregating swing pricing administration and portfolio management is necessary to avoid potential conflicts of interest.

The persons responsible for administering swing pricing will be tasked with accounting for these near-term costs. According to the Swing Pricing Adopting Release, these near-term cost considerations will be limited to: (1) spreads; (2) transaction-related fees and charges arising from effecting portfolio transactions as a result of the net redemptions or net subscriptions; and (3) borrowing-related costs incurred by the fund in order to meet a redemption request.

The Swing Pricing Amendments eliminated two considerations that were contemplated under the proposal. First, funds will not be required to consider the market impact costs associated with trading portfolio assets in response to a breach of the swing threshold. The Commission reasoned that "many funds may not be able to readily estimate market impact costs, as well as concerns that subjective estimates of market impact costs could grant excessive discretion in the determination of a swing factor." Second, the Commission eliminated the requirement that funds consider the value of assets purchased and sold. As support, the SEC cited the difficulties associated with a fund being able to timely obtain this information.

Swing Factor Upper Limit. The Swing Pricing Amendments will require a fund to establish and disclose a board-approved swing factor upper limit, which cannot exceed two percent of the fund's NAV per share. The proposal had not imposed a swing factor upper limit, on the basis that a universally applied ceiling would be inappropriate given the different market conditions, redemption activities and costs associated with different funds. However, the Commission stated its belief in the Swing Pricing Adopting Release that limiting the swing factor will help mitigate volatility and tracking error issues that could arise from the use of swing pricing.

Application of the Swing Factor. The Swing Pricing Amendments require a fund to adjust its NAV whenever net purchases or net redemptions exceed the swing threshold. If a fund's swing threshold is breached, the swing factor will be applied equally to all purchasing and redeeming shareholders, regardless of the size of their orders or whether such orders would likely create material trading costs for the fund. This could result in certain benefits or costs to

shareholders relative to other shareholders in the fund, which otherwise would not exist in the absence of swing pricing. For instance, a small investor is not likely to create significant liquidity costs for the fund on its own, but if such an investor were to redeem its shares on a day that the fund's net redemptions breached the swing threshold (*e.g.,* due to large net redemptions from institutional shareholders), the investor would receive a lower price than would otherwise be the case as a result of the downward NAV adjustment. Funds that offer multiple share classes must apply the swing factor equally to all of their share classes.

From an operational standpoint, a fund using swing pricing would need to monitor shareholder trades or flows of money into and out of the fund, for purposes of determining whether the fund's net purchases or net redemptions would cross the fund's swing threshold, thereby triggering the swing factor. The persons administering the fund's swing pricing policies and procedures may have limited time in which to make this determination. The Commission has expressed the need for funds to develop processes, and possibly establish policies and procedures, related to obtaining sufficient investor flow information from transfer agents about transactions conducted by intermediaries on behalf of investors. This information could include actual transactions effected before the fund calculates and publishes its NAV. However, the Commission noted that funds will likely rely on investor flow estimates to determine whether the swing threshold has been breached. As a best practice, the Commission suggested that funds conduct regular back-testing of their estimates against the actual investor flow information (received at a later date) to assess, update, and improve the accuracy of investor flow estimates.

Timely receipt of investor flow information is also critical for funds that will establish multiple swing factors, because the fund will determine which swing factor to apply based on the level of net fund flows. Effective communication channels between the various entities charged with implementing swing pricing would therefore be an essential component of any fund's swing pricing policies and procedures.

In recognition of the operational difficulties of implementing swing pricing, the Commission delayed the effectiveness of the Swing Pricing Amendments to "allow for the creation of industry-wide operational solutions in a more efficient manner." According to the Swing Pricing Adopting Release, "providing an extended effective date may more effectively facilitate the adoption of swing pricing."

Board Considerations. A fund's board (including a majority of the independent board members) will have to initially approve the fund's swing pricing policies and procedures. However, the fund's board will not be required to approve any material changes to the swing pricing policies and procedures. Instead, the fund's board must review a report prepared by the persons responsible for administering swing pricing. The report must address, at a minimum, the following:

- The Swing-Pricing Administrator's (as defined below) assessment of the swing pricing policies and procedures, and the effectiveness of their implementation;
- Any material changes to the swing pricing policies and procedures during the review period; and
- The Swing-Pricing Administrator's review and evaluation of the fund's swing threshold(s), swing factor(s) and swing factor upper limit.

Under the Swing Pricing Amendments, a fund's board, rather than the fund adviser, must designate the fund's investment adviser or officer(s) responsible for administering the fund's swing pricing policies/procedures (a Swing-Pricing Administrator). The Commission noted that a fund may wish to establish a swing pricing committee that would be responsible for administering the policies and procedures.

Disclosure and Reporting

Amendments to Form N-1A

Form N-1A currently requires funds to include a description of their policies and procedures for redeeming fund shares. Funds are required to disclose any restrictions or redemption charges, as well as other redemption information (such as the timing of payments to redeeming shareholders). In the Commission's view, however, there are various inconsistences in how funds describe their redemption policies and procedures, and investors would benefit from standardized disclosure regarding fund redemption practices. Accordingly, the final rule adopts the following amendments to Item 11 of Form N-1A.[53]

- ***Disclosure Regarding the Timing of Redemption Payouts***. Funds must disclose the number of days typically expected, or an estimated range of days, in which to pay redemption proceeds. The disclosed pay-out timing must be based on the method of payment (*e.g.*, by check, wire, or automated clearing house) chosen by the redeeming shareholder, rather than the distribution channel through which the redeeming shareholder generally transacts. The Commission noted that funds may wish to consider also disclosing whether payment of redemption proceeds may take longer than the typical number of days disclosed for such payment, and that such payment may take up to seven days as provided under the 1940 Act.
- ***Disclosure Regarding the Methods Used to Satisfy Redemptions***. Funds must describe the methods they typically expect to use to satisfy redemption requests (*e.g.*, sale of portfolio securities, cash reserves, lines of credit, interfund lending, or redemptions in kind), as well as whether such methods will be used regularly or only in stressed market conditions.

Funds that decide to use swing pricing also will be required to include an explanation in their registration statements regarding: swing pricing; the circumstances in which the fund will use swing pricing; and the effects of initiating swing pricing. In addition, such funds will be required to disclose the fund's swing factor upper limit(s).

Form N-PORT

Funds will be required to report each portfolio investment's liquidity classification on Form N-PORT. *Position-level* liquidity classification information will be reported on a non-public basis to the Commission and will not, as originally proposed, be released publicly on a quarterly basis. Form N-PORT will also require public reporting of *aggregate* percentages of a fund's portfolio investments in each liquidity category. This aggregate data will be publicly available with a 60-day delay. Also, as noted above, funds will be required to disclose on Form N-PORT the percentage of highly liquid investments segregated to cover, or pledged to satisfy margin requirements in connection with, derivatives transactions classified as moderately liquid, less liquid or illiquid. This information will also be publicly available quarterly with a 60-day delay.

In addition, a fund's HLIM will be reported to the Commission on Form N-PORT. If a fund's HLIM has changed during the reporting period, any prior HLIMs established during the reporting period must also be reported. Further, the number of days in the reporting period during which a fund experienced an HLIM Shortfall will be reported. A fund's HLIM reported on Form N-PORT will be non-public.

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[53] These amendments apply to all open-end funds, including money market funds and ETFs.

Form N-CEN

The Commission amended Part C of Form N-CEN to require funds to report certain information regarding lines of credit, interfund lending and borrowing and swing pricing. With respect to lines of credit, a fund must disclose: (1) whether it has an available line of credit; (2) whether each available line of credit is committed or uncommitted; (3) the size of each line of credit (in U.S. dollars); (4) the name of the institution providing the line(s) of credit; and (5) whether other funds in the fund complex may access the line(s) of credit and the names of such funds. There are additional disclosure requirements for any fund that draws on its line(s) of credit during the relevant reporting period.

If a fund engages in interfund lending and/or borrowing during any given reporting period, the fund must disclose the average amount of the loan when the loan was outstanding, as well as the period of time the loan was outstanding.

Finally, a fund will be required to disclose whether it used swing pricing during the relevant reporting period.

New Reporting Form N-LIQUID

Funds will be required to file reports with the Commission on new Form N-LIQUID when certain liquidity-related events occur. These reports will be non-public and will be required within one business day of the occurrence of an event specified in the form. Events triggering disclosure include:

- When more than 15% of fund net assets are, or become, illiquid;[54]
- If illiquid investments previously exceeded 15% of fund net assets, but have changed so that such investments are less than or equal to 15% of fund net assets;[55] and
- The occurrence of an HLIM Shortfall lasting more than seven consecutive calendar days.[56]

Financial Statement Reporting/Financial Highlights

The impact of swing pricing will need to be reflected in a fund's financial statements, including the fund's balance sheet and the notes to the financial statements. With respect to the notes to the financial statements, the Commission will require a fund to describe the fund's use of swing pricing during the relevant reporting period, including the effects of swing pricing on the fund's financial statements.

Recordkeeping

Funds (including In-Kind ETFs) must comply with the following recordkeeping requirements, which the Commission expects to be evaluated by its examination staff:

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[54] This event will trigger disclosure of the date(s) of such event, the current percentage of net assets that are illiquid investments and certain identifying information about the illiquid investments (name of issuer, title of issue or description of investment, CUSIP number (if any), one other identifier if available), as well as the percentage of fund net assets attributable to that investment.

[55] This event will trigger disclosure of the date(s) of such event and the current percentage of net assets that are illiquid investments.

[56] This event will trigger disclosure of the date(s) on which fund holdings of assets that are highly liquid investments fell below the HLIM.

- ***Liquidity Risk Management Policies and Procedures***. These policies and procedures must be maintained for a period of at least five years in an easily accessible place.
- ***Board Materials***. Any materials provided to the board in connection with its initial approval of a fund's liquidity risk management program must be maintained for a period of at least five years, the first two years in an easily accessible place.
- ***Reports on Adequacy of the Program***. Reports on the adequacy of the program and its implementation must be maintained for a period of at least five years, the first two years in an easily accessible place.
- ***Highly Liquid Investment Minimum***. If applicable, a written record of how a fund determined its HLIM (and any adjustments thereto) must be maintained for a period of at least five years, the first two years in an easily accessible place.
- ***Shortfall Policies and Procedures***. If applicable, any materials provided to the board in connection with any HLIM Shortfall must be maintained for a period of at least five years, the first two years in an easily accessible place.
- ***Swing Pricing Policies and Procedures***. These policies and procedures must be maintained for a period of at least six years in an easily accessible place. A fund also will be required to keep a copy of all supporting documents regarding any adjustments to the fund's NAV as a result of its swing pricing policies and procedures for a period of at least six years, the first two years in an easily accessible place. In addition, a fund will be required to maintain copies of any reports provided to the board by the persons responsible for administering swing pricing for a period of at least six years, the first two years in an easily accessible place.

Compliance and Effective Dates

- ***Liquidity Risk Management Program and Form N-LIQUID Filing Requirements***. A fund's compliance date depends on its asset size and/or the asset size of its related fund complex. For larger funds that, combined with other funds in the same complex, have net assets of $1 billion or more as of the end of the most recent fiscal year, the compliance date will be *December 1, 2018*. For smaller funds that, combined with other funds in the same complex, have net assets below $1 billion as of the end of the most recent fiscal year, the compliance date will be *June 1, 2019.*
- ***Disclosure and Reporting Requirements.*** All initial registration statement filings and post-effective amendments that are annual updates to effective registration statements must comply with the proposed amendments to Form N-1A by *June 1, 2017*. Similar to the compliance date for the liquidity risk management program requirements, the compliance date for the Form N-PORT and Form N-CEN filing requirements varies based on the fund's asset size. For larger funds, the compliance date will be *December 1, 2018*; for smaller funds, the compliance date will be *June 1, 2019*.
- ***Swing Pricing***. Based on operational concerns raised by commenters, the Commission delayed the effective date of the Swing Pricing Amendments until two years after the final rules are published in the Federal Register. The primary operational concerns relate to the difficulties in obtaining investor fund flow information from third parties, as well as the costs associated with developing the infrastructure to support the use of swing pricing.

Conclusion

Impact Generally. Although the Liquidity Rule addresses some of the concerns raised by industry participants, the Liquidity Rule, together with the related disclosure and reporting requirements, represents significant changes to current liquidity management and reporting requirements, particularly for fund complexes with less formal practices. The new rules and rule amendments will require significant, costly changes to fund operations, as well as disclosure and reporting requirements. Moreover, although the Liquidity Rule is unlikely to categorically restrict offering any particular investment strategy currently offered by funds in an open-end fund structure, the Liquidity Rule will likely require additional documentation and contingency planning for funds that invest in asset classes with extended settlement periods. In addition, the Liquidity Rule, particularly the requirements to assign a liquidity classification to the entirety of a fund's position in a particular investment (and not, as proposed, to portions of that position) and to consider the size of a fund's position in a particular investment, may cause a fund to determine that a greater percentage of its holdings is illiquid.

Impact on Fund Boards. While the Commission removed the more onerous, day-to-day management-like requirements contained in the Proposed Liquidity Rule, the Liquidity Rule still imposes significant new responsibilities on a fund's board, including standard review and approval requirements as well as event-driven review and approval tasks. In order to satisfy these responsibilities, boards may need to meet more frequently and outside of regularly scheduled board meetings. In addition, board members will likely become more active with respect to liquidity management practices, to assure themselves that, among other things, any particular investment strategy is appropriate for an open-end fund structure, and liquidity risk is being managed (although not necessarily eliminated) by the fund's investment adviser.

Impact on ETFs. The Liquidity Rule may have a significant impact on the day-to-day operations of ETFs, and will require ETF sponsors to consider operational and structural characteristics relating to the in-kind redemption process. An ETF that seeks to qualify as an In-Kind ETF must be able to determine that it meets the definitional requirements of such term, including that: redemptions are effected through in-kind transfers of securities, positions and assets other than a *de minimis* amount of cash; and portfolio holdings information is published daily. In adopting this *de minimis* standard, the Commission described the use of "small amounts" or "balancing amounts," but did not provide any guidance for this subjective definition. The definition of an "In-Kind ETF" also does not take into account the industry practice of allowing for relatively small portions of a redemption basket to be composed of cash or "cash-in-lieu" of securities under certain circumstances (including cases other than where a portfolio position is ineligible to be transferred in-kind, as noted by the Commission). ETFs that meet the definition of an "In-Kind ETF" thus may have to forego some operational flexibility.

For these reasons, in connection with determining whether an ETF should seek to qualify as an In-Kind ETF, an ETF sponsor should take into account the operational and compliance burden of satisfying the requirements under the Liquidity Rule that are applicable to ETFs (other than In-Kind ETFs). This evaluation may require consideration of the asset class and general liquidity characteristics of the ETF's portfolio securities, as well as such characteristics of the ETF's underlying index (for index-based ETFs). In the event that these requirements are less onerous than the operational requirements of maintaining only *de minimis* cash redemptions, an ETF sponsor may consider complying with the Liquidity Rule as an ETF (and not an In-Kind ETF).

As support for the Commission's position that In-Kind ETFs raise limited liquidity concerns, the SEC referred to the availability of an ETF's portfolio holdings information, as well as the availability of securities that comprise an index-based ETF's relevant underlying index. Accordingly, the Commission stated in the Liquidity Program Adopting Release that, even for ETFs not currently subject to daily transparency conditions under their exemptive orders, many

ETFs provide portfolio holdings information on a daily basis as a matter of practice. With respect to an underlying index, the SEC noted that the identity and weighting of constituent securities of an affiliated index are required to be made public under exemptive orders. However, in the context of a third-party index, while the Commission noted that the index compositions are generally publicly available to authorized participants for purposes of evaluating the liquidity profile, an ETF issuer may need to consider the availability of such information (which may be subscription-based or license-based), in order to comply with the Commission's portfolio transparency requirement for all In-Kind ETFs.

For more information on the new liquidity risk management program and swing pricing rules and rule amendments, please contact one of the authors listed below or the Dechert lawyer with whom you regularly work.

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