SEC Delays Compliance Dates for Certain Liquidity Rule Requirements; SEC Staff Issues Responses to Second Set of Liquidity Rule FAQs

A legal update from Dechert's Financial Services Group

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Dechert LLP

SEC Delays Compliance Dates for Certain Liquidity Rule Requirements; SEC Staff Issues Responses to Second Set of Liquidity Rule FAQs

The U.S. Securities and Exchange Commission (SEC) on February 21, 2018 adopted an interim final rule (Interim Rule) delaying for six months the compliance dates for certain requirements of Rule 22e-4 under the U.S. Investment Company Act of 1940 (1940 Act) (Liquidity Rule) and related reporting and board approval requirements.[1] On the same day, the Staff of the SEC's Division of Investment Management (Staff) issued responses to a second set of frequently asked questions (FAQs) related to the Liquidity Rule. The Staff's responses to these FAQs provide guidance as to liquidity classifications, compliance monitoring, and reporting requirements, among other matters related to the Liquidity Rule.[2]

Below is an overview of the original and revised implementation timelines of the Liquidity Rule's various requirements (ordered chronologically for larger fund complexes), as well as those of the SEC's new data reporting modernization rules (Modernization Rules). Definitions and further discussion follow.

	Original Compliance / Filing Date	Revised Compliance / Filing Date
Form N-CEN (*Modernization Rules)*[3]	June 1, 2018 for all funds	Unchanged
Compliance Date for Maintaining Information for Form N-PORT[4] (*Modernization Rules)*, excluding Liquidity	June 1, 2018 for larger fund complexes June 1, 2019 for smaller fund complexes	Unchanged for larger fund complexes March 1, 2020 for smaller fund complexes *Larger fund complexes must gather and maintain (but not file with the SEC) all of the data required by Form N-PORT (excluding liquidity*

1 Investment Company Liquidity Risk Management Programs; Commission Guidance for In-Kind ETFs, Release No. IC-33010 (Feb. 22, 2018) (Interim Rule Adopting Release). *See also* Investment Company Liquidity Risk Management Programs, Release No. IC-32315 (Oct. 13, 2016) (Liquidity Program Adopting Release). On March 7, 2018, the SEC announced an open meeting to be held on March 14, 2018 to consider, among other things, "whether to propose amendments to Form N-PORT and Form N-1A related to disclosures of liquidity risk management for open end management investment companies."

2 Investment Company Liquidity Risk Management Programs Frequently Asked Questions, Division of Investment Management (Feb. 21, 2018). The Staff issued responses to the first set of FAQs regarding the Liquidity Rule on January 10, 2018. For a summary of the Staff's responses to these FAQs, please refer to *Dechert OnPoint*, SEC Staff Issues Liquidity Rule Frequently Asked Questions.

3 The rescission of Form N-SAR and related rule amendments is effective as of the same date (*i.e.,* June 1, 2018).

4 Form N-PORT is a monthly reporting form that must be filed no later than 30 days after month-end. Thus, if a reporting requirement is applicable (for example, as of March 1), the Form N-PORT covering that month as of month-end (*i.e.,* March 31) would need to be filed within 30 days of March 31 (*i.e.,* April 30).

	Original Compliance / Filing Date	Revised Compliance / Filing Date
Classification and HLIM Information[5]		*classification and HLIM information) as of the original compliance date (i.e., July 30, 2018 relating to June 30, 2018 data)*
Implementation of Liquidity Program (*Liquidity Rule)*	December 1, 2018 for larger fund complexes June 1, 2019 for smaller fund complexes	Unchanged
Assessment, Management, and Periodic Review of Liquidity Risk (*Liquidity Rule)*		
15% Limit on Illiquid Investments (*Liquidity Rule)*		
Liquidity Related Board and SEC Reporting Requirements, excluding Liquidity Classification and HLIM Information (*Liquidity and Modernization Rules)*[6]		
Board Designation of Program Administrator (*Liquidity Rule)*		
Redemption In-Kind Policies and Procedures (*Liquidity Rule)*		
Amendments to Form N-CSR (*Modernization Rules)*[7]	June 1, 2018 for larger fund complexes June 1, 2019 for smaller fund complexes	March 1, 2019 for larger fund complexes March 1, 2020 for smaller fund complexes
Initial EDGAR Filing Date for Form N-PORT (*Modernization Rules)*, excluding Liquidity Classification and HLIM Information	July 30, 2018 (relating to June 30, 2018 data) for larger fund complexes July 30, 2019 (relating to June 30, 2019 data) for smaller fund complexes	April 30, 2019 (relating to March 31, 2019 data) for larger fund complexes April 30, 2020 (relating to March 31, 2020 data) for smaller fund complexes

5 The Temporary Rule requires larger fund complexes to gather and maintain (but not file with the SEC) all of the data required by Form N-PORT (excluding HLIM and liquidity classification information) as of the original reporting date, and such information will be subject to examination by the Staff. However, the new compliance date for the Liquidity Rule's HLIM and liquidity classification requirements as they relate to larger fund complexes (*i.e.,* June 1, 2019) is now later than the SEC-adjusted initial reporting date for Form N-PORT for larger fund complexes (*i.e.,* April 30, 2019, relating to March 31, 2019 data). Thus, larger fund complexes must maintain the corresponding HLIM and liquidity classification records beginning June 1, 2019.

6 In addition to board reporting requirements relating to the 15% limitation on illiquid investments, the SEC reporting requirements that are *not* subject to extension are: Form LIQUID's Part A (General Information), Part B (Above 15% Illiquid Investments), and Part C (At or Below 15% Illiquid Investments); Form N-CEN's Item C.20 (Lines of Credit, Interfund Lending, and Interfund Borrowing) and Item E.5 (In-Kind ETF).

7 The Temporary Rule delays for nine months the compliance date for the amendments to Form N-CSR that require the certifications regarding any change in the fund's internal control over financial reporting cover the semi-annual period rather than the fiscal quarter. Therefore, the compliance dates for the amendments to Form N-CSR will be: March 1, 2019 for larger fund complexes; and March 1, 2020 for smaller fund complexes.

<table>
<tr><th></th><th>Original Compliance / Filing Date</th><th>Revised Compliance / Filing Date</th></tr>
<tr><td>Liquidity Classification Requirements (Liquidity Rule)</td><td rowspan="5">December 1, 2018 for larger fund complexes
June 1, 2019 for smaller fund complexes</td><td rowspan="5">June 1, 2019 for larger fund complexes
December 1, 2019 for smaller fund complexes
Fund complexes must include HLIM and liquidity classification information in Form N-PORT reports as noted immediately below</td></tr>
<tr><td>HLIM and Shortfall Procedures (Liquidity Rule)</td></tr>
<tr><td>Initial Board Approval of Liquidity Program (Liquidity Rule)</td></tr>
<tr><td>Annual Board Reporting by Program Administrator (Liquidity Rule)</td></tr>
<tr><td>HLIM and Liquidity Classification Information Board and SEC Reporting Requirements (Liquidity and Modernization Rules)</td></tr>
<tr><td>Initial EDGAR Filing Date for HLIM and Liquidity Classification Reporting Requirements on Form N-PORT (Liquidity and Modernization Rules)</td><td>January 30, 2019 (relating to December 31, 2018 data) for larger fund complexes
July 30, 2019 (relating to June 30, 2019 data) for smaller fund complexes</td><td>July 30, 2019 (relating to June 30, 2019 data) for larger fund complexes
April 30, 2020 (relating to March 31, 2020 data) for smaller fund complexes</td></tr>
<tr><td>Rescission of Form N-Q (Modernization Rules)</td><td>August 1, 2019
Larger fund complexes would not have needed to file Form N-Q after July 30, 2018
Smaller fund complexes (and money market funds) would not have needed to file Form N-Q after July 30, 2019</td><td>May 1, 2020
Larger fund complexes will not need to file Form N-Q after April 30, 2019
Smaller fund complexes (except money market funds) will not need to file Form N-Q after April 30, 2020
Money market funds may continue to rely on the original Form N-Q rescission date of August 1, 2019</td></tr>
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Background of the Liquidity Rule

The Liquidity Rule generally requires registered open-end investment companies (other than money market funds) to adopt and implement written liquidity risk management programs (Liquidity Programs) reasonably designed to assess and manage their liquidity risk. Liquidity Programs must contain several elements, including:

- The assessment, management, and periodic review of a fund's liquidity risk;[8]
- The classification and monthly review of the liquidity of a fund's portfolio investments;

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8 For purposes of this *OnPoint*, registered open-end investment companies, including mutual funds (other than money market funds) and ETFs, are generally referred to herein as "funds." Under Rule 22e-4, a fund's 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 determination and periodic review of a fund's highly liquid investment minimum (HLIM) and procedures to address a shortfall;[9] and
- Compliance with the 15% limit on illiquid investments and related reporting requirements.

Additionally, a fund's board of directors/trustees must approve the designation of the person, or group of persons, responsible for administering the fund's Liquidity Program (Program Administrator).

Although the SEC's delay of the requirements summarized below is responsive in some respects to the requests by many industry participants, as well as Dechert,[10] the delay introduces a number of new considerations and challenges that funds may want to promptly address. Fund management may want to engage early with their funds' boards and independent counsel to continue the dialogue relating to planning for the implementation of the funds' Liquidity Program, including the staggered compliance dates of the various provisions of the Liquidity Rule and related reporting requirements.

The Staff's responses to the second set of FAQs provide guidance and clarification with respect to several of the more technical provisions of the Liquidity Rule, particularly certain components of the Liquidity Rule's classification requirements. However, other significant operational and interpretive questions and ambiguities remain. The SEC's extended compliance periods provide additional time for funds to further evaluate these questions and ambiguities as funds continue to work through the development of Liquidity Programs.

SEC Delays Compliance Dates for Certain Liquidity Rule Requirements

In adopting the Interim Rule, the SEC acknowledged the submission of numerous requests from industry participants to delay the compliance dates of the Liquidity Rule.[11] The Interim Rule Adopting Release describes the concerns expressed by many industry participants, which generally focused on the significant challenges to achieving timely compliance with the Liquidity Rule's classification requirements, as well as the need for additional time to complete the build-out of necessary systems and to allow for service providers' offerings to further mature. The SEC specifically recognized that, for most funds, "implementation is more complex than anticipated and the role for service providers is going to be more extensive than [the SEC] had originally understood, thereby resulting in even more complexity and raising interpretive questions." Although the SEC contemplated a longer delay, the SEC ultimately decided that a six-month extension period "should provide sufficient time" for funds to achieve compliance with the requirements of the Liquidity Rule subject to the extension.

Liquidity Rule and Related Requirements with Extended Compliance Dates

The Interim Rule delays the compliance dates for the following requirements of the Liquidity Rule and related SEC reporting forms for six months – with revised compliance dates of:
June 1, 2019 for larger fund complexes; and December 1, 2019 for smaller fund complexes:

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9 The Liquidity Rule exempts In-Kind ETFs (as defined in note 17 *supra*) from the liquidity classification and HLIM requirements. The Liquidity Rule also exempts from the HLIM requirement funds that "primarily" hold assets that are highly liquid investments.

10 Comment Letter to SEC, Dechert LLP (Jan. 10, 2018).

11 See, e.g., Investment Company Institute Letter to SEC Chairman Clayton (July 20, 2017) and Securities Industry and Financial Markets Association Letter to SEC Chairman Clayton (Sept. 12, 2017). For further information, please refer to *Dechert OnPoint*, ICI Requests Delay and Re-Examination of Liquidity Risk Management and Reporting Modernization Rules.

- Classification of each portfolio investment of a fund into one of four defined liquidity categories (or "buckets") based upon specified considerations, and at least monthly review of such classification;
- Determining and periodically reviewing an HLIM for relevant funds, adopting procedures to address a shortfall, and complying with related board reporting requirements;
- Initial board approval of the Liquidity Program;
- Annual board reporting by the Program Administrator;[12] and
- Liquidity classification and HLIM reporting requirements of Forms N-PORT and N-LIQUID.[13]

Liquidity Rule and Related Requirements with Compliance Dates as Originally Scheduled

The SEC did not delay the compliance dates for the remaining requirements of the Liquidity Rule and related reporting forms. The compliance dates for these requirements, as summarized below, remain: December 1, 2018 for larger fund complexes; and June 1, 2019 for smaller fund complexes.

- Implementing a Liquidity Program (including assessing, managing, and periodically reviewing a fund's liquidity risk);[14]
- Limiting illiquid investments to 15% of a fund's net assets and complying with certain related board and SEC reporting requirements associated with breaches of this 15% limit;
- Board designation of a Program Administrator;
- For funds that engage in, or reserve the right to engage in, redemptions in-kind, establishing policies and procedures regarding how they will engage in such redemptions in-kind; and
- All other reporting requirements of Forms N-PORT and N-LIQUID.

SEC Guidance on the 15% Illiquid Investment Limit

The SEC did not extend the compliance dates for the 15% illiquid investment limit under the Liquidity Rule, or related board and SEC reporting requirements. In declining to extend the compliance dates for these requirements, the SEC stated that, although the Liquidity Rule's definition of illiquid investments "differs in some respects" from relevant historical guidelines, the industry has experience in following the prior guidelines and should be able to apply that experience to comply with the 15% illiquid investment limit. **However, prior guidelines do not reflect the standard for compliance with the 15% limit during the extension period between initial implementation and final compliance dates**. The prior guidelines were consistent with assessing an investment's liquidity based on trading a single lot. However, the SEC expects funds to consider market depth and a trade size larger than a single lot in

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12 In delaying the compliance date for certain board-related aspects of the Liquidity Rule, the SEC expressed its belief that it would be "unnecessarily burdensome" to require boards to review Liquidity Programs before all necessary elements have been incorporated, and to conduct annual reviews of Liquidity Programs before the Liquidity Programs are completely developed.

13 The reporting requirements that are subject to extension are: Form N-LIQUID's Part D (Assets that are Highly Liquid Investments Below the HLIM); and Form N-PORT's Item B.7 (Highly Liquid Investment Minimum), Item B.8 (Liquidity Aggregate Classification Information), and Item C.7 (Liquidity Classification Information).

14 In the Interim Rule Adopting Release, the SEC stated that "[a]lthough funds will need to implement liquidity risk management programs as originally scheduled, these programs need not, for now, include the rule's classification or HLIM requirements." The SEC further stated that, "[o]ther than the elements that are not being delayed, funds may implement a program that achieves the goals laid out in the rule using any additional elements they view as reasonable during the period of the compliance date extension, but need not get board approval of that program until the end of the extension period."

complying with the 15% illiquid investment limit.[15] Thus, the SEC provided guidance with respect to complying with this limit for funds that do not engage in full liquidity classification during the extension period and for "In-Kind ETFs".[16]

The SEC outlined one "reasonable method" for a fund or an In-Kind ETF to seek to comply with the 15% illiquid investment limit during the extension period, but noted that funds and In-Kind ETFs may use other "reasonable approaches." The method described by SEC would include a "preliminary evaluation," which would be designed to preliminarily identify asset classes or investments that the fund or In-Kind ETF reasonably believes are likely to be illiquid based on, for example, the fund's or In-Kind ETF's previous trading experience or understanding of the general characteristics of the asset classes or investments.[17] This method could also include a "secondary evaluation" based on the full classification process of the Liquidity Rule for use when a fund or In-Kind ETF "wishes to further evaluate [the liquidity] status" of an investment established by the preliminary evaluation. The Interim Rule Adopting Release provides further guidance with respect to the details of this "reasonable method," including automation, periodic testing, related assumptions, and the potential liquidity impact of certain events.

SEC Staff Issues Responses to Second Set of Liquidity Rule FAQs

On the same day that the SEC delayed certain Liquidity Rule and related requirements, the Staff issued responses to a second set of FAQs (Nos. 16 – 34). The Staff's responses to these FAQs expand on the Staff's responses to a first set of FAQs, which provided the Staff's views on, among other matters, the manner in which responsibilities under a Liquidity Program may be delegated to third parties (including to a fund's sub-adviser), and the definition of "in-kind" ETF for purposes of the Liquidity Rule.

Asset Class Liquidity Classifications (FAQ Nos. 16 – 18)

The Staff's responses provide guidance on liquidity classifications according to asset classes – in particular, the Liquidity Rule's requirement for separate classification and review of investments within an asset class when "the fund or its adviser has information about any market, trading, or investment-specific considerations that are reasonably expected to significantly affect the liquidity characteristics of that investment as compared to the fund's other portfolio holdings within that asset class."[18] In FAQ Nos. 16-18, the Staff provided guidance on the process for identifying exceptions from asset class liquidity classifications. The Staff acknowledged that investments within a particular asset class "may be expected to exhibit a range of varying liquidity profiles." Moreover, the Staff recognized that overly sensitive exception processes might result in a number of false positives that could "limit the utility of this asset classification method in identifying true significant outliers" (*i.e.,* deviations that could have a significant effect on liquidity characteristics). The Staff explained that funds that classify and review investments according to their asset classes should include "a reasonable framework for identifying exceptions" in their policies and procedures (which may rely on automated processes), and that funds with such a framework "need not subsequently justify every

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15 For example, the SEC stated that "a fund could use any reasonable method ***in evaluating the market depth*** of the asset classes or investments it identifies as likely being illiquid in the preliminary evaluation." (emphasis added).

16 To qualify as an In-Kind ETF, an ETF must: (1) meet redemptions through in-kind transfers of securities, positions and assets other than a *de minimis* amount of cash; and (2) publish its portfolio holdings daily.

17 The SEC stated that "[a] fund could choose to determine that certain investments identified in such asset classes that it purchases are illiquid based solely on this preliminary evaluation, and not engage in any further analysis under the rule at that time" and that "[t]his evaluation need not occur prior to the trade being placed."

18 Rule 22e-4(b)(1)(ii)(A).

classification on a CUSIP-by-CUSIP basis."[19] However, the Staff expects these funds would periodically test the framework to determine whether it is operating properly.

Reasonably Anticipated Trading Size (FAQ Nos. 19, 20 and 21)

The Staff provided guidance on the Liquidity Rule's requirement to consider the "sizes that the fund would reasonably anticipate trading" and market depth when classifying investments. In FAQ No. 19, the Staff explained the application of this requirement in the context of asset class liquidity classifications, indicating the Staff's view that funds may conduct aggregated analysis for investments classified by asset class: *i.e.,* a fund could determine the reasonably anticipated trading size for all of the investments in a particular asset class and use that determination for purposes of market depth analysis and liquidity classification. However, the Staff stated that funds should "consider whether using fixed dollar amounts is a reasonable approach (instead of using percentages of the full position), because using fixed dollar amounts on positions of widely varying size may result in unreasonable trading sizes in some cases."

The Staff provided additional guidance with respect to the market depth analysis, explaining that a fund need not "predict which specific portfolio positions it will sell in advance or consider actual trades executed for reasons other than meeting redemptions," but a fund should "estimate a portion of an investment that it reasonably believes it could choose to sell to meet redemptions."

The Staff also explained that funds may make reasonable assumptions about reasonably anticipated trade sizes and use such assumptions throughout the classification process, even in cases where the fund anticipates liquidating a position for reasons unrelated to meeting redemptions in the near term. As an example, the Staff stated that a fund could use a *pro rata* approach (*i.e.*, assuming that the fund would sell "all portfolio investments *pro rata* in response to a redemption") as "a reasonable baseline assumption" for estimating the portion of investments to sell for redemption purposes.

Price Impact Standard (FAQ No. 22)

As part of the liquidity classification requirement, a fund must consider the number of days within which the fund can reasonably expect an investment to be convertible to cash (or sold or disposed of, as applicable) without significantly changing the market value of the investment. Addressing whether a fund must employ a single, fixed numerical price impact assumption in classifying all of its investments, the Staff explained that funds have flexibility in establishing the meaning of "significantly changing the market value" of an investment, and that funds need not use a single, fixed numerical price impact assumption for this purpose. Indeed, the Staff recognized that "what constitutes a significant change in market value may vary by fund, asset class, or investment," and "a fund does not need to employ as a price impact assumption a fixed amount or percentage."

Classifying Investments in Pooled Investment Vehicles (FAQ No. 23)

When considering the liquidity classification of an investment in another pooled investment vehicle, the Staff expressed its view that funds may "focus on the liquidity of the pool's shares or interests." For investments in pools the shares of which trade on exchanges, the Staff stated that "it may be appropriate for a fund to evaluate their liquidity in much the same way that it would evaluate the liquidity of other exchange-traded investments" and to "look through" to the vehicle's underlying investments generally only when "the fund has reason to believe that doing so

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19 The Staff emphasized in FAQ No. 18 that "there is no presumption that a fund that identifies *potential* exceptions must necessarily reclassify [an investment classified using an asset class methodology approach]." (emphasis in original).

could materially alter its view of the liquidity of the pool's shares." Similarly, for investments in pools offering redeemable securities or withdrawal rights, the Staff noted that it may generally be appropriate for a fund to "focus on the pool's ordinary redemption rights or practices" and to "look through" to the underlying investments only when "the fund has a reason to believe that the pool may not be able to honor those rights or meet redemptions in accordance with its customary practice."[20]

Provisional Classifications and Compliance Monitoring (FAQ Nos. 24, 25 and 26)

The Staff's response to FAQ No. 24 provides guidance on monitoring for compliance with the HLIM and 15% illiquid investment limit. The Staff expressed its belief that "regular monitoring is essential to compliance" with these requirements, and that a fund "should calculate the value of existing investments for this purpose in conjunction with its daily computation of net asset value." However, the Staff noted that such monitoring does not require funds to make liquidity reclassifications of existing investments on a daily basis, and that a fund may use the classifications "that it last verified" (generally as last reported on Form N-PORT).

The Staff's responses to FAQ Nos. 25 and 26 provide guidance for funds that might voluntarily choose to use provisional liquidity classifications (see also FAQ No. 32). In particular, the Staff noted that, where provisional classifications and compliance monitoring indicate potential compliance issues related to the HLIM or 15% limit on illiquid investments, funds should review these matters "in accordance with the funds['] reasonably designed policies and procedures" and, if such a compliance issue is verified "based on compliance monitoring or by finalizing a provisional reclassification," the applicable reporting requirements would be triggered.

Timing and Frequency of Liquidity Classifications (FAQ Nos. 27, 28 and 29)

The Staff also provided guidance on when a fund must initially classify a newly acquired investment or consider reclassification of an investment. The Staff noted that it would not object if a fund classifies new investments, or considers reclassification of existing investments, during the fund's next regularly scheduled monthly classification (other than as noted in FAQ Nos. 28 and 31). However, the Staff also provided guidance with respect to the more frequent liquidity classifications required under the Liquidity Rule if changes in relevant market, trading, and investment-specific considerations are reasonably expected to materially affect one or more classifications of a fund's investments.

The Staff clarified that it "does not believe that this intra-month review requirement creates a *de facto* ongoing review requirement for classification" and that the Staff "would not object if a fund complies with this intra-month review obligation by identifying in its policies and procedures events that it reasonably expects would materially affect" the liquidity classification of an investment. In particular, the Staff would not object if a fund limited the events triggering intra-month reviews to "objectively determinable" events (such as trading halts, delistings, issuer or counterparty default or bankruptcy, sovereign defaults or certain other extraordinary events). The Staff also clarified that, in such instances, a fund is required only to consider the reclassification of investments that the fund reasonably expects to be materially affected by the relevant change.

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20 The FAQs cite to the Liquidity Program Adopting Release at text following n. 524 (discussing certain circumstances where a fund may wish to look through an ETF to the ETF's underlying holdings if those holdings' liquidity may impair the liquidity of the ETF).

Pre-trade Activity and 15% Illiquid Limitation (FAQ Nos. 30 and 31)

The Staff provided guidance on pre-trade activity and its applicability to the 15% illiquid investment. The Staff explains that a fund is not required to classify or conduct related compliance monitoring on an investment prior to acquisition. Although a fund is not required to engage in pre-trade liquidity classifications, FAQ No. 31 details one reasonable approach that a fund might utilize with respect to intra-month investment acquisitions and compliance with the 15% illiquid investment limit or the HLIM during the period between scheduled monthly review and classifications. This approach relies on preliminary liquidity evaluations similar in substance and process to the guidance in the Interim Rule Adopting Release relating to compliance with the 15% illiquid limit in the interim period between the compliance date of the Liquidity Rule and the compliance date for the liquidity classification requirement. The Staff acknowledged that funds may use other reasonable approaches.[21]

Related Reporting Requirements (FAQ Nos. 32 and 33)

The Staff provided guidance on when a fund's reporting obligation is triggered for breaches of the 15% illiquid investment limit or the fund's HLIM. The Staff explained that a fund's reporting obligation commences once the fund verifies and makes a final determination that the fund exceeded the 15% illiquid investment limit or fell below its HLIM. The Staff acknowledged that a fund may need a reasonable amount of time for verification when, for example, its policies and procedures call for reclassification, or a provisional classification indicates a potential liquidity issue. However, the Staff stated that, in these circumstances, the verification and final determination process should "in general" be completed within three business days of the triggering event, including the day the triggering event was observed. "In those limited circumstances," a fund's reporting obligation "would be triggered not by the event itself, but instead when the fund has determined and verified (within three business days of the event) that the fund has in fact" breached the 15% limit or its HLIM. The Staff also provided its views on certain other reporting matters relating to Form N-LIQUID and breaches of the 15% limit on illiquid investments and a fund's HLIM.

ETFs and Investment Classification (FAQ No. 34)

The Staff acknowledged that an ETF that is not an In-Kind ETF (and thus is subject to the classification and HLIM provisions of the Liquidity Rule), but that nevertheless satisfies a large percentage of its redemptions in-kind, "may have a different liquidity profile, and face different liquidity risks, than a similar one that does not."[22] As such, the Staff noted its view that "it may be appropriate for such an ETF to reflect these differences in its classification procedures and in designating" an HLIM. Additionally, the Staff stated that ETFs may consider "reasonably anticipated in-kind redemption activity" in determining the appropriate reasonably anticipated trading size or market depth assumptions for its investments. However, the Staff further stated that "a zero or near zero reasonably anticipated trade size would transform any illiquid assets into highly liquid assets in a manner inconsistent with the Commission's intent in

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21 In discussing the automation of a preliminary evaluation of asset classes or investments and reasonably anticipated trade size considerations, the Staff noted: "In evaluating the likelihood of an asset class or investment being illiquid, ***we do not believe it would be reasonable to assume that a fund is only selling a single trading lot when looking at the market depth of the asset or class***. However, a fund would not need to evaluate the actual size of its holdings in the asset class or engage in the full process of evaluating its reasonably anticipated trading size for the asset class under the rule. Instead, a fund could use any reasonable method in evaluating the market depth of the asset classes or investments it identifies as likely being illiquid in the preliminary evaluation." (emphasis added).

22 In connection with its issuance of responses to the second set of FAQs, the Staff also revised its initial response to FAQ No. 13, which pertains to the methods an In-Kind ETF may use to test whether its cash use is *de minimis.* The Staff expanded its prior response by clarifying that "[a] fund may choose to use either its daily net or total redemptions for each day of the period of time it selects when determining whether its cash use is *de minimis*."

adopting rule 22e-4.” Finally, consistent with other statements in the FAQs, the Staff noted that “the rule’s reasonably anticipated trading size requirement presupposes a size greater than a single trading lot.”

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