# DROWNING IN LIQUIDITY: THE SEC'S NEW LIQUIDITY MANAGEMENT RULE FOR MUTUAL FUNDS (PART 1)




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## I. LIQUIDITY RULE BACKGROUND

Adopted by the Securities and Exchange Commission ("SEC" or "Commission") in 2016 and due to become effective over the coming months for some fund groups, Rule 22e-4 (the "Liquidity Rule" or "Rule") under the Investment Company Act of 1940 (the "1940 Act") has presented mutual funds and their managers with the need to develop a compliance infrastructure to manage and monitor the liquidity of their funds in the specific manner contemplated by the Rule. Implementation of that infrastructure presents funds and their managers with considerable compliance challenges and interpretive questions.[1] As detailed below, the Liquidity Rule generally requires all mutual funds, other than money market funds, to establish liquidity risk management programs ("Liquidity Programs" or "Programs").

In response to industry concerns, the staff of the SEC Division of Investment Management (the "Staff") issued two sets of frequently asked questions ("FAQs") in early 2018, and the Commission amended the Liquidity Rule to alleviate certain implementation burdens in June 2018. Despite these developments, potential operational and regulatory implications of the Liquidity Rule present challenges to fund groups as they prepare for the Rule's effectiveness and the implementation of their various Liquidity Programs. Although the SEC has signaled the potential for further guidance and consideration of industry feedback, the industry continues to grapple with many aspects of the Rule and is quickly approaching deadlines for going live with these Programs.

Section I of this outline provides a broad overview of the legal and regulatory background of the Liquidity Rule and its related regulatory guidance. Section II discusses certain implementation matters confronting many fund groups, depending on their existing liquidity risk management processes and the nature of their investment products.[2]

### A. Overview of Rule 22e-4

Under section 22(e) of the 1940 Act, funds must make payment on a shareholder's redemption request within seven days of receiving such request. Notwithstanding this statutory seven-day window under the 1940 Act, the settlement period for redemptions has generally shortened in practice, because of, among other things, technological advances in settlement infrastructure and shortened settlement periods imposed on security trades (including fund share redemptions) effected by broker-dealers.[3] Accordingly, funds and their investment advisers must manage the liquidity risk of their funds in a manner consistent with redemption obligations that are more demanding than funds' redemption obligations under the statutory provisions of the 1940 Act.

The Liquidity Rule represents a partially principles-based, partially prescriptive regulatory approach by the SEC designed to ensure that funds are able to appropriately meet their redemption obligations

without unfairly diluting the interests of their remaining shareholders. Specifically, the Liquidity Rule requires funds to adopt and implement written Liquidity Programs that include the following key elements:

- **Assessment, Management, and Periodic Review of Fund's Liquidity Risk.** Subject to consideration of certain specified factors, funds will be required to assess, manage, and periodically review their "liquidity risk" (as defined below).
- **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. Funds must review these classifications at least monthly.
- **Determination of Highly Liquid Investment Minimum ("HLIM").** Some funds will be required to establish a minimum percentage of net assets that must be invested in "highly liquid investments," and to implement policies and procedures for responding to a "shortfall" in the HLIM.
- **Fifteen percent Limit on Illiquid Investments.** The Rule imposes a 15 percent limit on a fund's acquisition of "illiquid investments" that are assets.[4]

Under the Liquidity Rule, a fund's board will also be required to initially approve the fund's Liquidity Program and designate an administrator responsible for administering the Program ("Program Administrator"). In addition, the Liquidity Rule imposes new disclosure and reporting requirements related to a fund's Liquidity Program.

The compliance dates are staggered for various aspects of the Liquidity Rule and vary based on whether the fund complex is considered "large" or "small" for this purpose (generally, assets of greater than or less than $1 billion as of the most recent fiscal year end). As discussed below, the SEC delayed the original compliance dates in February 2018 for *certain* aspects of the Liquidity Rule. The key compliance dates are currently as follows:

*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);
- Limiting illiquid investments to 15 percent of a fund's net assets and complying with certain related board and SEC reporting requirements associated with breaches of this 15 percent 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;[5] and
- All reporting requirements of Forms N-PORT and N-LIQUID other than those with the June 1, 2019 or December 1, 2019 compliance dates, as noted below.

*June 1, 2019 for larger fund complexes and December 1, 2019 for smaller fund complexes*

- 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; and
- Liquidity classification and HLIM reporting requirements of Forms N-PORT and N-LIQUID.

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

### a. Liquidity Risk

Funds must assess, manage, and periodically review (no less frequently than annually) their "liquidity risk," taking into account certain specified factors.[6] "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 Programs must address the potential dilution of remaining fund investors' interests that may be caused by a fund's method of meeting redemptions. As observed in the Adopting Release, a "fund that chooses to sell its most liquid assets to meet fund redemptions may minimize the 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." Accordingly, adequately assessing and managing liquidity risk under the Rule would generally require considering and addressing the method(s) by which portfolio assets may be sold for the purpose of meeting shareholder redemptions, so as to seek to avoid a potentially significant dilution in value or a significant change in risk profile for remaining investors' interests.[7]

The SEC's understanding of and general views on mutual fund liquidity risk appear to have been most recently informed by the adverse selling pressures and liquidity issues experienced by the Third Avenue Focused Credit Fund ("Third Avenue") during the Rule's pendency (*i.e.*, as the Commission considered the Rule between its proposal and adoption).[8] Third Avenue, a mutual fund that invested predominately in distressed debt and had limited cash reserves, requested and obtained exemptive relief from the SEC to suspend redemptions to shareholders. Following a period of heavy redemptions, Third Avenue reported the fund had become increasingly concentrated in its distressed debt holdings, and the fund determined that it would need to sell these portfolio securities at disadvantageous "fire sale" prices to continue to meet shareholder redemption requests. As such, Third Avenue could not meet its redemption obligations without first liquidating its portfolio holdings in a manner and at prices that would unfairly disadvantage the fund's remaining shareholders.[9] Once it had obtained relief from the Commission to suspend shareholder redemptions, Third Avenue proceeded with a plan of orderly liquidation. With respect to the exemptive order given to Third Avenue, the Adopting Release stated that, with the adoption and regulatory framework of the Liquidity Rule in place, "there is no assurance that the Commission would grant similar relief in the future."

### b. Liquidity Risk Factors

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

- 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";[10]
- Short-term and long-term cash flow projections during both normal and reasonably foreseeable stressed conditions;[11] and
- Holdings of cash and cash equivalents, as well as borrowing arrangements and other funding sources.[12]

The 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 15 percent 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 be able to find purchasers for those investments during stressed periods"). For example, the Commission noted in several places that investments with long settlement periods (more than seven days), such as certain bank loans, warrant particular consideration under the Liquidity Rule.

## 2. Liquidity Classification of Portfolio Investments

The Liquidity Rule requires funds 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.

### a. Liquidity Categories

The liquidity of fund portfolio investments must be classified in one of the four following categories (often referred to as liquidity "classifications" or "buckets"):

- **Highly liquid investments:** Cash and any investment reasonably expected to be "convertible to cash" in current market conditions in three

business days or less without significantly changing the market value of the investment.[13]

- **Moderately liquid investments:** 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.[14]
- **Less liquid investments:** 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.[15]
- **Illiquid investments:** 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 Adopting Release, the Commission stated 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, 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.

### b. Classification Inputs

Under the Liquidity Rule, a fund may choose to classify its portfolio investments (including derivatives transactions) on an investment-by-investment basis or an asset class basis. In either case, the fund's classifications must be based on information obtained after "reasonable inquiry" and must take into account "relevant market, trading and investment-specific considerations." 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 derivatives transactions in each classification category other than highly liquid. These requirements are discussed in detail below.

#### i. Liquidity Determinations on an Asset Class Basis

Funds are *permitted* to classify the liquidity of portfolio investments according to asset class, instead of an investment-by-investment basis. 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 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;[16] and (2) certain high-quality corporate bonds' bid-ask spreads were significantly wider or more volatile than those of their peers. Additionally, the 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.[17]

According to the 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 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 common or preferred. In determining asset classes, the Commission stated that 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

Adopting Release refers to as "exception processes") for updating default classifications based on market, trading, and investment-specific considerations. According to the 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.

### ii. Market, Trading, and Investment-Specific Considerations

With respect to making individual liquidity classifications, the Commission stated that it 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 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 suggested for consideration when classifying liquidity of portfolio investments 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]
- 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]

### iii. 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.

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)."

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, which 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 percent limit for illiquid investments.

### iv. 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 that are 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 (*i.e.*, for

purposes of determining whether the HLIM 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 liquidity of the derivative instruments they are covering. Such guidance likely would have represented a significant change in current segregation practice for many funds.[25] Instead, under the approach taken by the Liquidity Rule, funds generally need not specifically identify particular assets segregated or pledged to cover derivatives transactions.

### c. 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 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).

## 3. Highly Liquid Investment Minimum

Under the Liquidity Rule, a fund that does not "primarily" hold assets that are highly liquid investments must: (1) determine a HLIM (*i.e.*, the fund's minimum percentage of net assets that must be invested in highly liquid investments), taking into consideration the applicability of the Liquidity Risk Factors to the fund; (2) periodically review, no less frequently than annually, the HLIM; and (3) adopt policies and procedures for responding to a "shortfall" of the HLIM ("HLIM Shortfall Policies and Procedures"). Notably, the HLIM requirement does not function to 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 being 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 Proposing Release, the Commission stated that it would be "extremely difficult" to conclude that a HLIM of zero would be appropriate.

### a. Consideration of Liquidity Risk Factors

A fund must consider the Liquidity Risk Factors when determining its HLIM, but only inasmuch as the Factors apply during normal conditions and during stressed conditions reasonably foreseeable during the period until the next periodic review of the HLIM.[26] The Adopting Release noted that the Commission's guidance regarding the Liquidity Risk Factors in the assessment of liquidity risk 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 Adopting Release stated 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 coverage 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.[27]

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.

#### b. Highly Liquid Investment Minimum Shortfall Policies and Procedures

Under the Liquidity Rule, a fund's HLIM Shortfall Policies and Procedures must require that the Program Administrator: (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 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 – thus, providing some flexibility in developing these procedures. However, the Commission suggested that HLIM 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 HLIM Shortfall Policies and Procedures where the fund regularly encounters HLIM Shortfalls.

#### c. Review of Highly Liquid Investment Minimum

The Liquidity Rule requires that funds review their HLIMs (or determination that an HLIM is not necessary) no less frequently than annually. The board need not approve the HLIM, although board approval may be required to change the HLIM in certain circumstances, as described below in Section I.B.3.b. 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.

#### d. 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 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 Adopting Release did provide guidance, stating that, "if a fund held less than 50 percent of its assets in highly liquid investments, it would be unlikely to qualify as 'primarily' holding assets that are highly liquid investments."[28] The Commission noted that, because of 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.

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 that are classified as moderately liquid, less liquid, or illiquid investments.

### 4. Fifteen Percent Limit on Illiquid Investments

The Liquidity Rule prohibits the acquisition by a fund of any illiquid investment if, immediately after the acquisition, the fund would have invested more than 15 percent of its net assets in illiquid investments that are "assets."[29] The Liquidity Rule effectively codifies the

Commission's historical limit on investments in illiquid assets and supersedes previous SEC guidance regarding illiquid investment limits, which could have an important impact on funds (including money market funds, which are not subject to the Liquidity Rule).[30]

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 disposition significantly changing the market value of the investment.[31] 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 both for purposes of the general classification framework described above and for purposes of the 15 percent limit. For example, 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, as opposed to making this determination on the basis of discrete trade lots alone. 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 percent 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 does not require a fund to divest illiquid investments if the fund's holdings of illiquid investments exceed the 15 percent limit. However, the Commission stated that "a fund should not be permitted to exceed the 15 percent limit on illiquid investments for an extended period of time without board oversight," and, therefore, exceeding the 15 percent 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 percent 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 percent limit "within a reasonable amount of time."[32] 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 percent 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 percent limit continues to be in the fund's best interest.[33]

### 5. Unit Investment Trusts

In the Adopting Release, the SEC noted that most unit investment trusts ("UITs") "serve as separate account vehicles used to fund variable annuity and variable life insurance contracts, and these UITs essentially function as pass-through vehicles, investing principally in securities of one or more open-end investment companies that would be subject to [the Liquidity Rule]." Under the Liquidity Rule, 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 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 percent 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.[34]

### 6. Related Disclosure and Reporting Requirements

- **Form N-1A:** To standardize disclosure regarding fund redemption practices, Item 11 of Form N-1A was amended to require disclosures regarding (i) the timing of redemption payouts and (ii) the methods used to satisfy redemptions. Following the June 2018 amendments, as discussed below, funds must include in their annual or semi-annual report a brief discussion of the "operation and effectiveness of the fund's liquidity risk management program over the past year," including any liquidity events that materially affected the fund's performance.

**Form N-PORT:** Funds must report each portfolio investment's liquidity classification, as well as the percentage of highly liquid investments segregated to cover moderately liquid, less liquid, or illiquid derivatives transactions, on Form N-PORT. Following the June 2018 amendments, as discussed below, the aggregate classifications are no longer publicly disclosed every quarter. A fund must also report its HLIM on Form N-PORT.

**Form N-CEN:** The Liquidity Rule 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.

**Form N-LIQUID:** The Liquidity Rule created a new Form N-LIQUID, on which funds must file reports within one business day of certain liquidity-related events, such as when more than 15 percent of fund net assets are, or become, illiquid.

## B. Board Oversight

In connection with the requirement that each fund establish a Liquidity Program, the Liquidity Rule imposes new oversight responsibilities on a fund's board, including: (1) initially approving the fund's written Liquidity Program; (2) approving the Program Administrator; and (3) reviewing (at least annually) a written report regarding the operation and effectiveness of the Liquidity Program prepared by the Program Administrator. In addition, as discussed below, the board has certain oversight responsibilities with respect to a fund's HLIM and investments in illiquid investments based on occurrences relating to the fund's liquidity events.

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 Program.[35] The SEC stated that board involvement is intended to protect investors by ensuring that redemption requests may be satisfied without diluting remaining investors, to whom board members continue to owe fiduciary duties. However, despite requests for clarification by the fund industry, the Commission noted that the board oversight role in the context of administering the Liquidity Program is similar to its role in other contexts governed by the 1940 Act, making a specific standard unnecessary.

### 1. Initial Approval of the Liquidity Program

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

In connection with reviewing and considering the approval of a Liquidity Program, the SEC did not prescribe factors that a board should consider. Generally, a board may be guided by a variety of factors that it or any of its members may deem relevant, which may generally include but are not limited to, for example, the applicable fund's management structure (*e.g.*, whether the fund is sub-advised or multi-managed), the fund's asset classes and strategies (*e.g.*, whether the fund invests in fixed income or derivative instruments), the fund's size and investor base, any historical liquidity events, applicable industry practices, and the proposed role(s) of third party vendors in the Liquidity Program.

### 2. Approval of 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 (as detailed in Section II below), 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 particularly necessary for Liquidity Programs that, for example, rely on sophisticated models.

### 3. Other Responsibilities

#### a. Review of Annual Report from Program Administrator

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 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 percent limit on illiquid investments; and
- 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.

#### b. Non-recurring HLIM and Illiquid Investment Duties

In situations where the Program Administrator seeks to make a change to a fund's HLIM at a time when the fund's highly liquid investments are below the pre-established minimum, the board (including a majority of independent board members) is required to first consider and approve such change. Further, 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 the HLIM Shortfall to the board within one business day.

The Program Administrator must also provide the board with a report within one business day if a fund's illiquid investments exceed the 15 percent limit on illiquid investments. In the report, the Program Administrator must explain the cause and extent of the fund exceeding the 15 percent 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 percent limit. As discussed above, the board has additional responsibilities if a fund's illiquid investments remain above the 15 percent limit for more than 30 consecutive days (and each 30-day period thereafter).

## C. Industry Reactions and Liquidity Rule Developments

### 1. Industry Comments to Proposed Rule and SEC Responses

The SEC proposed the Liquidity Rule in September 2015, following a sweep by the SEC Staff on funds' liquidity management. Although the fund industry was generally in support of some type of principles-based liquidity risk management approach, industry participants provided extensive comments on a number of the features of the Proposing Release. 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.

#### a. Liquidity Classification of Fund Investments

Under the Proposing Release, 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 Proposing Release (*e.g.*, 2-3 business days versus 4-7 calendar days).[36]

As adopted, the SEC ultimately reduced the number of classifications from six to four categories and required funds to 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.

### b. Three-Day Liquid Asset Minimum

The Proposing Release 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 HLIM requirement which, in some respects, is more flexible than the TDLA Minimum. For example, in response to the comments received on the Proposing Release, Primarily Highly Liquid Funds are not subject to the HLIM requirement.

### c. Role of the Board in Liquidity Management

Under the Proposing Release, a fund's board would have been required to, among other things: (1) initially approve the fund's Liquidity Program, including the TDLA Minimum; and (2) approve any material changes to a fund's Liquidity Program, including any changes (material or otherwise) to the TDLA Minimum. Industry commenters opposed these requirements for several reasons, including because 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 HLIM (except in limited circumstances) or to approve material changes to the fund's Liquidity Program.

## 2. Staff Guidance: The January FAQs

As adopted, the Liquidity Rule posed a number of coordination challenges for funds whose liquidity risk management, as well as related compliance responsibilities, had traditionally been divided between various parties. Additionally, investment advisers that provided services to multiple fund groups faced the prospect of having to potentially reconcile their management services between fundamentally different Liquidity Programs.

In January 2018, the Staff published its first set of responses to FAQs regarding the Liquidity Rule ("January FAQs").[37] The January FAQs provide a pragmatic framework for delegating responsibilities under a fund's Liquidity Program to third parties, including a fund's sub-adviser. The January FAQs also make clear that the fund's Liquidity Program should provide clear authority to the Program Administrator to delegate certain responsibilities, as well as any limitations or conditions on the ability to delegate these responsibilities. Furthermore, the FAQs suggest that a fund's Liquidity Program (and any ancillary policies and procedures) should include: (1) a process to resolve any disagreements or conflicts among those parties to whom responsibilities have been delegated (to the extent the responsibility is delegated to more than one person); and (2) an oversight component to adequately supervise the parties to whom responsibilities have been delegated and to reasonably ensure that they are carrying out their responsibilities in a manner consistent with the fund's Liquidity Program.

### a. Delegation of Responsibilities[38]

In the January FAQs, the Staff explicitly acknowledged that a fund's Program Administrator may delegate responsibilities under the fund's Liquidity Program to third parties, including the fund's sub-adviser, "subject to appropriate oversight." The FAQs also note that an entity with delegated responsibilities may sub-delegate some of those responsibilities to other third parties. However, the Staff emphasized that, regardless of whether a fund's Program Administrator delegates all or a portion of its responsibilities, the fund "at all times retains ultimate responsibility for complying with the rule." In addition, the Staff noted that a fund "may wish to implement policies and procedures regarding the scope of" any delegation by the Program Administrator, and the Program Administrator "may, in turn, wish to implement policies and procedures to oversee those to whom it has delegated responsibilities."

The Staff further explained that, if a fund's Program Administrator delegated responsibility to classify the liquidity of the fund's portfolio investments to either the fund's investment adviser or sub-adviser, "that entity's decisions would control how the fund classifies its investments." However, if a fund's Program Administrator delegated responsibility to classify the liquidity of the fund's portfolio investments to both the fund's investment adviser and sub-adviser, the Staff noted that a fund's Liquidity Program "could address how the fund would resolve" any differing views on the liquidity of a particular portfolio investment. The Staff then provided the following "illustrative" examples of how a fund's Liquidity Program could address these differing views: (1) identify the specific entity whose liquidity classifications control; (2) establish another method to determine which liquidity classification would control (*e.g.*, a factor analysis or hierarchy); or (3) adopt the most conservative (*i.e.*, least liquid) classification.

#### b. Differing Responsibilities under Multiple Liquidity Programs; Different Liquidity Classifications Across Funds[39]

The Staff recognized that investment advisers and sub-advisers may provide advisory services to funds in multiple fund groups and that advisers and sub-advisers may have different responsibilities under each such fund's Liquidity Program. The Staff explained that a fund's Liquidity Program should be "tailored to the fund's risks and circumstances" and acknowledged that differences in Liquidity Programs may occur.

The Staff stated that an adviser or sub-adviser is "under no obligation to reconcile": (1) the elements of different Liquidity Programs; (2) the underlying methodologies, assumptions or practices of different Liquidity Programs; or (3) the outputs of different Liquidity Programs (including the liquidity classifications of fund investments). However, the Staff noted that, even though an adviser and sub-adviser may have responsibilities under different Liquidity Programs, a fund's board-approved Liquidity Program would always govern how that adviser or sub-adviser implements its responsibilities for that particular fund. As a result, the Staff acknowledged that funds may "appropriately arrive at different [liquidity] classifications for the same instrument" based on a particular fund's assumptions as to market and trading conditions and the particular circumstances informing its analysis.

#### c. Differing Liquidity Classifications for Multi-Manager Funds[40]

For funds that employ two or more sub-advisers, where each sub-adviser manages its own distinct "sleeve" ("Multi-Manager Funds"), the Staff acknowledged that sub-advisers may come to differing judgments as to the liquidity of a particular portfolio investment that is held in each sleeve. Under these circumstances, the Staff stated that "neither the fund, program administrator, nor the adviser nor the sub-advisers with delegated [Liquidity Program] responsibilities would be under any obligation to resolve these differences for compliance purposes (*e.g.*, in connection with monitoring for compliance with the fund's [HLIM] (if applicable) and the 15 percent limit on illiquid investments)." Accordingly, for purposes of complying with a fund's HLIM or 15 percent limit on illiquid investments, a Multi-Manager Fund could potentially have holdings in a particular portfolio investment where a portion of that investment is classified in one liquidity category while another portion of that same investment is classified in a different liquidity category. The Staff noted, however, that a fund's Liquidity Program could have a process for resolving these differences.

### 3. Staff Guidance: The February FAQs[41]

In February 2018, the SEC issued responses to a second set of FAQs ("February FAQs") that address interpretive and logistical questions that have arisen in connection with the Liquidity Rule's liquidity classification requirements and, in general, promote a more flexible, streamlined approach to implementing the Liquidity Rule. For example, the February FAQs state that funds that intend to classify the liquidity of investments according to asset class should establish in their policies and procedures a "reasonable framework for identifying exceptions" (which may include automated processes) and thus do not need to make shadow classifications on an investment-by-investment basis. The Staff also 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 February FAQs also discuss the timing and frequency of liquidity classifications. Notably, the Staff dispelled the notion that the Liquidity Rule creates a *de facto* requirement to review liquidity classifications on a continuous basis, noting that a fund may limit

intra-month classifications to the occurrence of "objectively determinable" events, such as a trading halt, default, or significant macro-economic development, among others. The February FAQs also address other compliance- and reporting-related questions, as listed below.

### a. Asset Class Liquidity Classifications[42]

As discussed above, the Liquidity Rule requires separate classification and review of investments within an asset class when a fund or its adviser is aware of "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."[43] In February 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 classification on a CUSIP-by-CUSIP basis."[44] However, the Staff expects these funds would periodically test the framework to determine whether it is operating properly.

### b. Reasonably Anticipated Trading Size[45]

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 February 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.

### c. Price Impact Standard[46]

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. 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."

### d. Classifying Investments in Pooled Investment Vehicles[47]

When considering the liquidity classification of an investment in another pooled investment vehicle, such

as an ETF, 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 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."[48]

### e. Provisional Classifications and Compliance Monitoring[49]

The Staff's response to February FAQ No. 24 provides guidance on monitoring for compliance with the HLIM and 15 percent 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 February 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 percent 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.

### f. Timing and Frequency of Liquidity Classifications[50]

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 February 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.

### g. Pre-trade Activity and Fifteen Percent Illiquid Limitation[51]

The Staff provided guidance on pre-trade activity and its applicability to the 15 percent 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, February FAQ No. 31 details one reasonable approach that a fund might utilize with respect to intra-month investment acquisitions and compliance with the 15 percent illiquid investment limit or the HLIM during the period between scheduled monthly review and classifications. This approach relies on preliminary liquidity evaluations. The Staff acknowledged that funds may use other reasonable approaches.[52]

### h. Related Reporting Requirements[53]

The Staff provided guidance on when a fund's reporting obligation is triggered for breaches of the 15 percent 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 percent 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 percent 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 percent limit on illiquid investments and a fund's HLIM.

## 4. February 2018 Interim Final Rule

In February 2018, the SEC adopted an interim final rule ("Interim Rule") delaying for six months the compliance dates for certain requirements of the Liquidity Rule and related reporting and board approval requirements.[54] 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. 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.

The SEC did not extend the compliance dates for the 15 percent 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 percent illiquid investment limit. However, prior guidelines do not reflect the standard for compliance with the 15 percent 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 complying with the 15 percent illiquid investment limit.[55] 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.

## 5. June 2018 Amendments

In June 2018, the SEC adopted amendments to the Liquidity Rule (the "Amendments") that primarily: (1) replace the requirement that funds publicly disclose their aggregate liquidity classification information on Form N-PORT with a new requirement under Form N-1A that funds discuss the operation and effectiveness of their liquidity risk management program in their annual or semi-annual report to shareholders; and (2) permit funds to classify a single investment into multiple liquidity classification "buckets" in three specified circumstances.[56] The Amendments provide that a portfolio investment may have multiple liquidity classifications under certain circumstances, including when there are multiple sub-advisers. Additionally, partly in response to comments from industry participants as to the benefits of the liquidity classification requirements set forth in the Liquidity Rule, the Amendments Release appears to invite industry participants to seek exemptive relief if they "believe they would have to maintain dual liquidity classification programs as part of their liquidity risk management." As discussed further below, the Amendments Release also notes that the SEC and

the Staff will continue to evaluate the implementation of the Liquidity Rule, signaling the possibility of further enhancements to the Rule in the future.

### a. Replacing Aggregate Liquidity Classifications with New Narrative Discussion

The Amendments remove the requirement that funds publicly report their aggregate liquidity classification information on Form N-PORT. Instead, the Amendments add a new sub-item to Form N-1A that requires funds to include in their annual or semi-annual report a brief discussion of the "operation and effectiveness of the fund's [Liquidity Program] over the past year." In a departure from the proposed amendments and in response to industry commenters, the Amendments add the narrative discussion to a new subsection of the shareholder report rather than folding it into management's discussion of fund performance.[57]

A fund must provide the narrative discussion in the shareholder report that covers the most recent fiscal half-year in which the fund's board of directors reviewed the fund's Liquidity Program as required by the Liquidity Rule. The SEC noted that providing funds with flexibility to include the discussion in either the annual or semi-annual report enables funds to synchronize the production of the disclosure with the board's annual review of Liquidity Programs, and thereby reduces the costs associated with producing the disclosure. According to the Amendments Release, the discussion "generally should provide a high level summary of the report that must be provided to the fund's board under [the Liquidity Rule] addressing the operation of the fund's [Liquidity Program] and the adequacy and effectiveness of its implementation."

The SEC further explained that the discussion "should provide investors with enough detail to appreciate the manner in which a fund manages its liquidity risk, and could, but is not required to, include discussion of the role of the classification process, the 15 percent illiquid investment limit, and the [HLIM] in the fund's liquidity risk management process." The SEC noted that a fund may consider including in the discussion "particular liquidity risks that it faced over the past year, such as significant redemptions, changes in the overall market liquidity of the investments the fund holds, or other liquidity risks, and explain how those risks were managed or addressed." The SEC also noted that a fund may wish to provide in the discussion "context and other supplemental information about how liquidity risk is managed in relation to other investment risks of the fund" or "other empirical data metrics such as the fund's bid-ask spreads, portfolio turnover, or shareholder concentration issues (if any) and their effect on the fund's liquidity risk management."

### b. Classifying an Investment under Multiple Liquidity Buckets

Expanding on the January FAQs, the Amendments revise Form N-PORT to permit a fund to classify a portfolio holding into two or more liquidity buckets in the following three circumstances: (i) if a fund has multiple sub-advisers with differing liquidity views; (ii) if portions of the position have differing liquidity features that justify treating the portions separately;[58] or (iii) if the fund chooses to classify the position through evaluation of how long it would take to liquidate the entire position (rather than basing it on the sizes it would reasonably anticipate trading).[59] If a fund chooses to classify an investment under multiple liquidity buckets, the fund is required to indicate which of these three circumstances prompted the multiple classifications, and the fund is permitted to provide additional context (in the explanatory notes section of Form N-PORT) regarding the circumstance that led to the multiple classifications.

### c. Exemptive Relief and Continuing Evaluation for Further Changes

In 2017, the U.S. Department of the Treasury recommended that the SEC embrace a "principles-based approach to liquidity risk management rulemaking and any associated bucketing requirements."[60] In the release proposing the amendments, the SEC requested comments on the Treasury Department's recommendations. A number of industry participants submitted comment letters that continued to question the benefits of the specific liquidity classification requirements under the Liquidity Rule, and some industry participants noted that they would continue to maintain their existing liquidity risk management practices alongside the Liquidity Programs required under the Rule. In response, the SEC stated that "funds that believe they would have to maintain dual liquidity classification programs as part of their liquidity risk management may choose to seek an exemption from the [SEC] from the classification requirements of [the Liquidity Rule] if they believe that their existing systems would effectively accomplish the [SEC]'s stated goals." However, the SEC declined to state whether,

under what circumstances, and subject to what conditions, it would grant such relief.

However, in response to industry commenters, the SEC noted in the Amendments Release that the Staff will continue to evaluate the implementation and disclosure of liquidity classifications, and seeks to receive industry feedback. The SEC stated that it expects the Staff's evaluation to include consideration of a "year's worth" of liquidity classification information and to consider: "(i) the costs and benefits of [the Liquidity Rule] and its associated classification requirements; (ii) whether there should be public dissemination of fund-specific liquidity classification information; (iii) whether the [SEC] should propose amendments to [the Liquidity Rule] to move to a more principles-based approach in light of this evaluation; (iv) and whether the [SEC] should propose to require certain empirical data metrics be disclosed." The SEC indicated that, after this evaluation, it expects the Staff to advise whether further changes are recommended.

## II. LIQUIDITY PROGRAM IMPLEMENTATION

As detailed in Section I above, the Liquidity Rule represents significant changes to current liquidity management and reporting requirements under the 1940 Act. On balance, the subsequent guidance and amendments to the Rule help to provide a generally pragmatic framework to funds as they attempt to begin to formalize their proposed Liquidity Programs. Significant operational challenges and interpretive ambiguities nevertheless remain, particularly with respect to the portfolio liquidity classification requirement. Moreover, the implementation of any approach chosen by a fund that involves reliance on third parties to implement and operate the Program will require additional contractual arrangements and oversight mechanisms.

### A. General Commentary

#### 1. Overview of Industry Progress

As the industry approached the first significant compliance date, December 1, 2018, many funds proposed a Program Administrator as they continue to further evaluate and refine the written Program as well as the establishment of supporting arrangements, such as third party vendors (and possibly back-up vendors) and technological systems. In addition, many funds continue to engage with a number of internal and external groups on key processes and considerations and have begun operational testing of some aspects of their Program. Many funds also continue to further educate fund boards on management's views on liquidity risk, the appropriate structure for the Program and the timeline for key milestones – in general, the overall process around adequately informing funds about the Rule and obtaining the necessary board approvals for a Liquidity Program is likely to be a multiple-meeting process. In addition, some funds are beginning to work with boards or a sub-set of boards to develop agreed-upon reporting conventions with respect to the Liquidity Programs once operational.

For many funds, the broad strokes of the Liquidity Programs are largely finalized but the process of determining key assumptions for purposes of, for example, liquidity classifications, remains an area of continued focus. In particular, factors such as the "value impact standard" and "reasonably anticipated trade size" often require considerable analysis and are aspects of the Rule that permit a certain amount of flexibility to tailor approaches to the specific funds and products—and may be appropriate for input from a variety of internal external groups, including risk, compliance, legal, investment, trading and other teams. In addition, many funds are considering the use of "interim" procedures for the period from the initial compliance date until the full classification system is in place and, in this regard, are revisiting their current liquidity determination procedures in light of the SEC's guidance in the Interim Rule Adopting Release and the FAQs.

In general, although states of preparedness and approaches to address the Liquidity Rule may vary across the industry, fund groups remain focused on the applicable compliance dates as they continue to develop, evaluate, test and refine their Liquidity Programs and related policies and procedures.

#### 2. Overview of Select Industry Practices — Industry Survey

Fund groups may be assisted in the implementation of their Liquidity Programs with insights into how other industry members are approaching the Liquidity Rule. In August 2018, the ACA Compliance Group published survey results of fund groups and investment advisers covering certain topics relating to the Liquidity Rule.[61] The survey group consisted of 32 fund groups and 45 advisers, 94 percent of which identified themselves as "larger fund groups" with net assets of $1 billion or more. It is clear from the groups survey that there is

no one size fits all approach for developing and implementing Programs.

- **Composition of Program Administrator:** More than 70 percent of fund group respondents indicated that primary investment advisers—more specifically, committees of adviser personnel—will be designated as Program Administrators. No respondent indicated that an individual or sub-adviser will be designated as Program Administrators.

- **Program Adoption:** Half of the fund group respondents indicated that their fund boards intended to be aware of the interim liquidity risk management programs by the December 2018 compliance date but not approve the full programs until the June 2019 compliance date. 31 percent of fund group respondents indicated that their fund boards intended to approve interim liquidity risk management programs by the December 2018 compliance date and re-approve the full programs with additional provisions for the June 2019 compliance date.

- **Delegation of Liquidity Classification Responsibilities:** 84 percent of the adviser respondents indicated that they were responsible for classifying fund securities into liquidity buckets.

- **Frequency of Liquidity Classifications:** 59 percent, 13 percent, and 25 percent of fund group respondents indicated they would classify portfolio investments on a monthly, weekly, or daily basis, respectively; for adviser respondents, results were similarly 62 percent, eight percent, and 24 percent for the same.

- **Methodology of Liquidity Classifications:** Of the 38 adviser respondents that indicated they had been assigned the role of classifying fund securities, 61 percent said they plan to use a third-party vendor to carry out this responsibility. 21 percent remained undecided. Only 18 percent will build in-house capabilities for the purpose of making liquidity classifications.

- **Asset Classification:** 35 percent of fund group respondents and 39 percent of adviser respondents indicated that they plan to use asset class-based classifications. Notably, 25 percent of fund group respondents and 33 percent of adviser respondents remained undecided at the time of the survey.

- **Primarily Highly Liquid Funds:** 44 percent of respondents have not yet decided on how to define "primarily" for the purpose of the Primarily Highly Liquid Funds exemption, whereas 20 percent lean towards using the SEC's view of the meaning of "primarily." 22 percent of respondents do not intend to rely on this exemption.

### B. General Considerations for Liquidity Programs and Related Policies and Procedures

In addition to the general interpretive issues and decisions associated with the Liquidity Rule, fund groups that offer multiple or specialized types of funds might grapple with particularly novel or complex implementation issues, given the fund-specific nature of the Liquidity Risk Factors and other requisitely tailored aspects of Liquidity Programs under the Rule.

For instance, fund groups that offer parallel general and specialized funds through different distribution channels or for different purposes (e.g., a fund open to retail investors and a parallel insurance-dedicated fund) may, notwithstanding the substantially identical portfolios of these funds, have Liquidity Programs that contemplate different assumptions, methodologies or approaches for each product. The different investor bases of these otherwise parallel funds may result in different cash flow models, such that one fund (the general fund open to institutional and retail investors, as was Third Avenue) might reasonably anticipate more liquidity pressures and uncertainty from shareholder redemptions than would the parallel fund (the specialized fund dedicated to insurance products). Of course, these conclusions depend on the particular facts and circumstances.

Broadly, the requirements of the Liquidity Rule apply similarly to retail and insurance-dedicated funds. However, the SEC contemplated in the Adopting Release that Liquidity Programs would be designed to account for and reflect the facts and circumstances of the particular funds. In the context of insurance-dedicated funds, factors such as cash flow and redemption history, may be materially different from retail funds pursuing the same strategy or otherwise require a tactical analysis. For example, the Adopting Release states that a "fund may wish to evaluate whether the size, frequency, and volatility of its shareholder flows follow any discernible patterns (for example, patterns relating to seasonality[.]" Accordingly, for purposes of determining assumptions such as "reasonably anticipated trade size" funds may wish to take into account any cyclical,

seasonal or otherwise gradually structured redemptions that occur in connection with asset allocation or other models that periodically adjust allocations and, thus, carry redemptions. Other characteristics of insurance-dedicated funds, in comparison to retail funds, may also lead to unique considerations in connection with the establishment of key assumptions and methodologies underlying Liquidity Programs, including the ability or inability of funds to satisfy redemption obligations through in-kind redemptions.

### C. Delegation and Oversight for Sub-Advised Funds

#### 1. Delegation of Program Responsibilities to Sub-Advisers

As discussed above, the January FAQs and the June 2018 Amendments to the Liquidity Rule contemplate the manner in which responsibilities under a fund's Liquidity Program may be delegated to third parties, including to a fund's sub-adviser. The FAQs articulate the Staff's view that, where appropriate, a sub-adviser may be designated by a fund's board as the Program Administrator. A board overseeing a fund managed by a single sub-adviser may wish to designate that sub-adviser as the Program Administrator in view of the sub-adviser's existing responsibilities, including the responsibility for making the portfolio management decisions that underlie the fund's liquidity risk profile. A sub-adviser may be less appropriate for this designation, however, if a fund has more than one sub-adviser (that is, a Multi-Manager Fund) or if the sub-adviser provides more limited services, as may be the case with certain smaller, boutique sub-advisers that may possess neither the staff nor the systems necessary to fully assume the non-investment-related responsibilities under a Liquidity Program (for example., annual board reporting). In this regard, a fund that wishes to designate a sub-adviser as the Program Administrator should consider whether such an arrangement could be supported by an existing compliance framework, where the sub-adviser has already assumed other substantial compliance responsibilities for the fund. Of course, this would depend on an assessment of the capabilities specific to an individual sub-adviser—regardless of size.

For these same reasons, a board overseeing a sub-advised fund may wish to designate the fund's primary adviser as the Program Administrator, in light of the adviser's existing fund administration, operations, risk management, and compliance framework with the fund. Importantly, the FAQs explicitly acknowledge that such a Program Administrator would nonetheless retain the flexibility to delegate specific Liquidity Program responsibilities to the fund's sub-adviser (as well as other third parties), subject to the Program Administrator's "appropriate oversight" and any fund policies and procedures governing the delegation.

For example, a fund whose primary adviser serves as its Program Administrator may consider its sub-adviser(s) as more knowledgeable with respect to the liquidity of the fund's investments. Under these circumstances, on the recommendation of such a Program Administrator, a board may wish to allocate the responsibility (or permit the Program Administrator to allocate the responsibility) to classify the liquidity of such investments to the sub-adviser(s). The FAQs also state that the Program Administrator may use a hybrid approach, whereby both the primary adviser and sub-adviser contribute to the fund's liquidity classifications. If a sub-adviser in such delegation arrangements wishes to further sub-delegate or otherwise rely upon a third-party service provider to fulfill its Liquidity Program responsibilities, as may occur if it were to rely on a specialized third-party service to classify the fund's portfolio investments, the fund's Liquidity Program must permit sub-delegation and provide for corresponding diligence of the third party (as discussed in Section II.C.2 below).

Notably, to the extent that the investment-related responsibilities delegated under these arrangements involve the incorporation of broader fund-specific inputs (for example, taking into account the fund's anticipated redemptions or deferring to the Program Administrator with respect to determining an investment position's reasonably anticipated trading size), a fund could instruct its Program Administrator to provide those fund-specific assumptions to the fund's sub-adviser(s) on an ongoing or periodic basis. For a Multi-Manager Fund, the FAQs provide that the arrangement between a fund's Program Administrator and its sub-advisers would be subject to the same considerations as above, with the exception that the sub-adviser's delegated responsibilities would apply with respect to only its distinct sleeve, not the fund as a whole.

Although the FAQs provide funds with significant flexibility to delegate Liquidity Program responsibilities, the FAQs also emphasize that compliance with the Liquidity Rule is ultimately the responsibility of the fund. As such, the Program Administrator should "oversee any

liquidity risk monitoring or risk management activities undertaken by the fund's service providers" and may wish to clearly articulate how any conflicts in liquidity classification would be addressed.

Even without the delegation of specific responsibilities under a Liquidity Program to a sub-adviser, the Program Administrator may find that it is helpful to obtain input from a sub-adviser on key assumptions relating to a fund, such as reasonably anticipated trade size or the value impact standard, and report to the fund's board that such input was sought, obtained and considered in connection with the development of the Liquidity Program.

### 2. Appropriate Oversight of Delegated Responsibilities

The Adopting Release and the FAQs do not discuss what constitutes "appropriate oversight" of delegated Liquidity Program responsibilities. In the absence of specific guidance, one possible approach is for the Program Administrator to supervise delegated responsibilities through a process along the lines of that used to comply with Rule 38a-1 under the 1940 Act. In the SEC's adopting release for Rule 38a-1, the SEC stated that "[a] chief compliance officer should diligently administer…oversight responsibility by taking steps to assure herself that each service provider has implemented effective compliance policies and procedures administered by competent personnel. The chief compliance officer should be familiar with each service provider's operations and understand those aspects of their operations that expose the fund to compliance risks." Using a similar approach, the Program Administrator's oversight processes under a Liquidity Program could, therefore, mirror an adviser's processes for overseeing other delegated functions, such as proxy voting. Based on this framework, we have identified below a number of practices that one may wish to consider when delegating responsibilities under a Liquidity Program to a sub-adviser (or to other servicers, as applicable).

#### a. Initial Due Diligence

If the primary adviser serves as Program Administrator and contemplates delegating certain responsibilities under a Liquidity Program to a sub-adviser, the Program Administrator should satisfy itself that the sub-adviser's Liquidity Program-related controls, written policies and procedures, and testing functions are reasonably designed to prevent violations of the Rule—this could involve use of a written questionnaire or other methods. The Program Administrator should also consider whether delegated responsibilities will be carried out by individuals whose roles are sufficiently separate from the portfolio management team, such as risk management and/or compliance personnel.

When the Program Administrator has delegated to the sub-adviser responsibility for making liquidity classifications, the Program Administrator should generally understand the sub-adviser's proposed methodologies, inputs, and assumptions. In addition, the Program Administrator could ask the sub-adviser how it intends to satisfy the requirement to make a reasonable inquiry in obtaining relevant information. If the sub-adviser plans to classify investments by asset class, rather than on an investment-by-investment basis, the Program Administrator should consider whether the sub-adviser has adopted procedures that define such asset classes meaningfully and with particularity. The Program Administrator can also, on a periodic basis, assess the sub-adviser's procedures for identifying exceptions as a result of market, trading, or issuer-specific considerations.

The Program Administrator may also wish to consider the frequency of classifying a fund's portfolio investments and whether such classifications will be primarily conducted internally or by an independent party. The Program Administrator should determine the extent to which the sub-adviser's processes for complying with specific liquidity thresholds, including the HLIM (if applicable), the 15 percent limit on illiquid investments and any client-specific guidelines, have been incorporated into its compliance software. Given the volume of data possibly generated in connection with a Program, a Program Administrator should also review the sub-adviser's documentation processes and its means for safeguarding potentially sensitive fund holdings information. The FAQs provide that a sub-adviser could sub-delegate some or all of its delegated responsibilities to another party, subject to appropriate oversight. If a sub-adviser intends to sub-delegate to a third-party vendor, the Program Administrator should determine how the sub-adviser will appropriately supervise that vendor. In addition, the Program Administrator should appropriately apprise the board of these oversight activities.

#### b. Ongoing Oversight

Once a Liquidity Program is operational, the Program Administrator should monitor the sub-adviser's implementation of the fund's Program. To the extent that the Program Administrator periodically conducts onsite

assessments of the sub-adviser, the Program Administrator might spend time reviewing the sub-adviser's liquidity risk management-related compliance systems, meeting with personnel responsible for administering the Liquidity Program, and discussing liquidity risk management practices with the sub-adviser's portfolio managers. For Program Administrators that oversee Multi-Manager Funds and engage numerous sub-advisers, the Program Administrator could focus its attention on sub-advisers that invest primarily in less liquid or illiquid investments (or investments with longer settlement periods or that trade infrequently). In calibrating its level of appropriate oversight, the Program Administrator may also wish to consider other factors, including: the degree to which the sub-adviser relies on manual processes; the level of subjectivity in its liquidity determination procedures; the sub-adviser's size, strategy, and organizational complexity, and experience managing assets subject to the requirements of the 1940 Act; and the frequency of past compliance errors.

To supervise a sub-adviser's liquidity classification responsibilities, a Program Administrator could test a sample of the investments held by the fund, ideally those representing a range of asset classes. The Program Administrator could also engage a third-party vendor for these purposes. However, given the subjectivity of liquidity classifications, the Program Administrator should generally establish "tolerance ranges" to accommodate differing views as to the liquidity of a particular portfolio investment. The Program Administrator should also consider whether it will retain the ability to challenge and/or override specific liquidity category determinations—and how to evaluate deviations from vendor provided classifications.

To mitigate compliance risk, the Program Administrator could require the sub-adviser to provide periodic reports or certifications regarding the operation of the Liquidity Program, particularly if the sub-adviser already provides such reports or certifications for other compliance purposes. Such reports might contain, for example, information regarding Liquidity Program compliance errors, fluctuations in the portfolio's liquidity profile, and a summary of material changes to the sub-adviser's liquidity risk management procedures and processes. The Program Administrator should request more detailed information as part of its annual 15(c) information request letter and consider the appropriate level of detail to provide to the board in its annual report.

The Program Administrator may want to consider whether its own procedures will foster continuity in the fund's Liquidity Program in the event that a sub-adviser experiences a temporary business disruption or is terminated. If the Program Administrator expects that it would administer a fund's Liquidity Program directly in those circumstances, the Program Administrator should consider whether it would assume responsibility for making liquidity determinations, or engage a third-party vendor to do so, subject to the Program Administrator's oversight. The Program Administrator should be aware of the potential impact to the fund's liquidity classifications and compliance with the HLIM or 15 percent limit on illiquid investments that might result following the replacement of a sub-adviser with another that uses different classification methodologies and inputs. To address this risk, the Program Administrator could impose guidelines that require the sub-adviser to maintain a buffer with respect to the HLIM or 15 percent limit.

## III. CONCLUSION

Although challenges remain, recent guidance and rulemaking by the SEC and its Staff should at least partially allay certain concerns from the mutual fund industry regarding the potential complexity of developing and implementing Liquidity Programs. Notwithstanding the Rule's somewhat prescriptive approach, the FAQs and Rule amendments generally contemplate a flexible framework to address the numerous compliance and operational challenges presented by the Rule, allowing for variation in liquidity risk management and burdens. Collectively, these measures provide fund groups with more flexibility to tailor liquidity risk management practices to their unique structures, risk tolerances and investment products.

Notes

1 Investment Company Liquidity Risk Management Programs, Investment Company Act Rel. No. 32315 (Oct. 13, 2016) ("Adopting Release"); 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"). In conjunction with the Liquidity Rule, the SEC adopted new rules and forms, as well

as amendments to certain rules and forms, to modernize the reporting of information by registered investment companies. Investment Company Reporting Modernization, Investment Company Act Rel. No. 32314 (Oct. 13, 2016).

2 This outline is not intended to provide a complete summary of considerations that may apply to all mutual funds but rather highlights certain issues that may be generally relevant for mutual funds and their service providers. Furthermore, this outline does not focus on the application of the Liquidity Rule to funds other than mutual funds, such as to exchange-traded funds ("ETFs"), which receive a tailored approach for significant aspects of the Liquidity Rule.

3 See Adopting Release, supra note 1, at nn.8–11 and accompanying text (discussing broker-dealer settlement requirements and the growth of the asset management industry (including with respect to less liquid and alternative strategies) as the primary impetus for the Liquidity Rule); see also Securities Transaction Settlement Cycle, Securities Exchange Act Rel. No. 80295 (Mar. 22, 2017) (subsequent to the adoption of the Liquidity Rule, shortening the required settlement period for broker-dealers from three to two days).

4 If a fund breaches the 15 percent limit, the occurrence must be reported to the fund's board of directors/trustees ("board"), together with an explanation of how the fund intends to bring its illiquid investments back into compliance with the 15 percent limit within a reasonable period of time. Additionally, 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.

5 Although not covered in this outline, the Adopting Release provides a discussion of the SEC's views on what these policies and procedures generally should address, including the particular circumstances in which a fund might employ in-kind redemptions, and related points that funds may wish to consider, such as potentially including different procedures for different shareholder types.

6 The board also provides oversight and review of a fund's Program, as discussed in Section I.B below.

7 See Adopting Release, supra note 1, at 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.").

8 See id. at nn.12, 81-84, 164, 171, 214, 588, 773 and accompanying text (citing events involving Third Avenue to clarify the SEC's concerns with respect to liquidity risk management).

9 Notably, Third Avenue represented to the SEC that, if it was not permitted to suspend redemptions, it would most likely be the fund's retail shareholders (as opposed to its institutional shareholders) that would suffer from the anticipated further declines in the fund's net asset value and further diminished liquidity of the fund's portfolio. See Third Avenue Trust and Third Avenue Management LLC, Investment Company Act Rel. No. 31943 (Dec. 16, 2015).

10 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 Proposing Release—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."

11 The Adopting Release noted that the Proposing Release's five separate sub-considerations relevant to this factor were eliminated from the Liquidity Rule's text. Instead, they are included in the 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.

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

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

14 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."

15 The Commission noted that, "[i]n the event of an extended settlement period, at some point, a fund may need to consider reclassifying" a less liquid investment as illiquid.

16 The Adopting Release did not describe the types of "adverse events" that would require a fund to separately classify any equity investment, but the Staff separately provided guidance on this point in the February FAQs, as discussed below at Section I.C.3.f.

17 The 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."

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 stated: "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."

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 Adopting Release stated that "corporate bond issuers commonly have large numbers of bonds outstanding, and trading can be fragmented among that universe of bonds." However, the 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 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* Adopting Release, supra note 1, 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 *See* Adopting Release, *supra* note 1, at n.470 and accompanying text (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").

26 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.

27 See Adopting Release, supra note 1, at Section III.D.2.b.

28 This footnote in the Adopting Release 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.

29 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.

30 The Adopting Release indicated that the Commission is withdrawing existing guidance contained in the following releases regarding the 15 percent limit on illiquid investments, as well as guidance regarding the process for determining the liquidity of an asset, as follows: 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).

Fund groups should consider whether this withdrawal of guidance could impact the operation of their money market funds, which may have previously relied on the now-withdrawn guidance when determining whether a portfolio holding is an "illiquid security" under Rule 2a-7 under the 1940 Act.

31 Accordingly, the Commission harmonized its codification of the 15 percent 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 percent limit). By contrast, the Proposing Release would have required a fund to use a separate standard for classifying the fund's assets for purposes of the 15 percent limit.

32 The SEC anticipates that, if a fund exceeds the 15 percent limit at any time during the year, the written report to the board regarding the adequacy and effectiveness of the fund's Liquidity Program would discuss the breach. If a fund continues to breach the 15 percent 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 percent limit within a reasonable period of time.

33 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 percent limit for more than 30 days.

34 In conducting this liquidity review, it may be helpful to consider broader guidance and practices, notably February FAQ (defined below) No. 23, which discusses how one may approach liquidity classification of an investment in another pooled investment vehicle. A summary of this FAQ is provided below.

35 *See* Mary Jo White, Chair, SEC, 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).

36 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.

37 Investment Company Liquidity Risk Management Programs Frequently Asked Questions, Division of Investment Management (Jan. 10, 2018).

38 *See* January FAQ Nos. 1 and 6.

39 *See* January FAQ Nos. 3, 4, and 5.

40 See January FAQ No. 7. Related January FAQ No. 8 was generally superseded by the June 2018 amendments to the Liquidity Rule.

41 Investment Company Liquidity Risk Management Programs Frequently Asked Questions, Division of Investment Management (Feb. 21, 2018).

42 See February FAQ Nos. 16–18.

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

44 The Staff emphasized in February 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]."

45 See February FAQ Nos. 19–21.

46 See February FAQ No. 22.

47 See February FAQ No. 23.

48 The February FAQs cite to the Adopting Release, supra note 1, at n.524 and accompanying text (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).

49 See February FAQ Nos. 24–26.

50 See February FAQ Nos. 27–29.

51 See February FAQ Nos. 30 and 31.

52 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).

53 See February FAQ Nos. 32 and 33.

54 Investment Company Liquidity Risk Management Programs; Commission Guidance for In-Kind ETFs, Release No. IC-33010 (Feb. 22, 2018) ("Interim Rule Adopting Release").

55 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."

56 Investment Company Liquidity Disclosure, Investment Company Act Rel. No. 33142 (June 28, 2018) ("Amendments Release").

57 The Amendments Release provides, however, that a fund may be required to discuss in management's discussion of fund performance any liquidity events that materially affected the fund's performance. The discussion should include sufficient information so that investors "can understand the liquidity event, how it affected performance, and any other relevant market conditions." In addition to the liquidity-related disclosures included in a shareholder report, the SEC noted in the Amendments Release that a fund is required to disclose liquidity risk in the fund's prospectus if that is a principal risk of the fund.

58 The SEC explained that differing liquidity characteristics may occur, for example, if a fund holds a put option on a portion of a portfolio holding, or if a fund purchases restricted securities in a private offering and makes additional purchases of the same security in the public market.

59 The SEC clarified that, in addition to using multiple classifications for reporting purposes on Form N-PORT, funds may use multiple classifications in their Liquidity Programs for compliance purposes.

60 A Financial System That Creates Economic Opportunities: Asset Management and Insurance, U.S. Dep't of the Treasury (Oct. 2017). In the report, the Treasury Department noted the importance of Liquidity Programs for investment companies for "effective fund management and the health of the financial markets," but recommended that the SEC postpone the liquidity classification requirement and replace it with a less prescriptive, more principles-based approach to liquidity risk management.

61 Greg Saitz, Most Boards Will Wait on Approving Liquidity Program, Board IQ (Aug. 28, 2018), http://boardiq.com/c/2068843/244013; Jill Gregorie, Shops' Plans for Classifying Holdings: Monthly, at First, Ignites (Aug. 22, 2018), http://ignites.com/c/2066083/242883; Jill Gregorie, Shops Torn on Liquidity Bucketing Methods, Ignites (Aug. 24, 2018), http://ignites.com/c/2068213/242733.