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Time to Get With the (Liquidity Risk) Program: SEC Issues Liquidity Risk Management Rule for Open-End Funds

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Executive Summary

On October 13, 2016, the Securities and Exchange Commission ("SEC") adopted new Rule 22e-4 ("Liquidity Rule") under the Investment Company Act of 1940 ("1940 Act"), which requires registered open-end funds, including open-end exchange-traded funds ("ETFs") but excluding money market funds and closed-end funds, to establish and implement written Liquidity Risk Management Programs ("LRMPs").[1] The SEC also amended fund reporting forms, and adopted new forms, mandating disclosure of liquidity-related information to the SEC and to the public.[2] In a separate adopting release, the SEC adopted new paragraph (a)(3) of Rule 22c-1 under the 1940 Act ("Swing Pricing Rule"), which permits open-end funds, other than money market funds and ETFs, to use "swing pricing."[3] Swing pricing

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[1] Investment Company Liquidity Risk Management Programs, SEC Release No. IC-32315 (Oct. 13, 2016) (the "Adopting Release"), www.sec.gov/rules/final/2016/33-10233.pdf. Unless otherwise indicated, references to "funds," "mutual funds," and "open-end funds" do not include money market funds or closed-end funds.

[2] For additional information on new disclosure and reporting obligations, see the related K&L Gates Client Alert, SEC Issues Investment Company Reporting Modernization Rules (Nov. 3, 2016), http://www.klgateshub.com/details/?pub=SEC-Issues-Investment-Company-Reporting-Modernization-Rules-11-03-2016.

[3] Investment Company Swing Pricing, SEC Release No. IC-32316 (Oct. 13, 2016), www.sec.gov/rules/final/2016/33-10234.pdf. The Swing Pricing Rule will be the subject of a separate K&L Gates Client Alert.

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allows a fund to adjust its net asset value ("NAV") to pass on the costs associated with heavy trading activity to purchasing or redeeming shareholders.

According to the Adopting Release, in adopting the new rules, the SEC aims to reduce "liquidity risk," defined as the risk that a fund could not meet requests to redeem fund shares without significant dilution of the remaining investors' interests in the fund. The SEC points to industry developments that underscore the need for rulemaking, including increasing shareholder inflows into funds with less liquid investment strategies, such as fixed income, emerging market debt, and so-called "alternative" asset classes and strategies. Evolving redemption practices, including shortening settlement periods, also underlie the reforms. The SEC notes that while settlement periods for trading fund shares have shortened, generally to three business days ("T+3") or shorter, settlement periods for some portfolio securities that funds hold—such as bank loans—have not fallen correspondingly, and can exceed seven business days, the maximum time in which funds must pay redeeming investors.[4]

The Liquidity Rule as originally proposed[5] in September 2015 garnered significant comments from the investment management industry. As adopted, the rule hews to the same framework in the proposal—requiring a written LRMP, overseen by a fund's board of directors, the classification of fund assets ranging from highly liquid to illiquid, and the establishment of a minimum level of liquidity for each fund. However, the SEC modified the final rule by, among other things, (1) reducing the liquidity classification categories from six to four, and permitting a fund to classify investments based on asset class; (2) permitting a fund to conduct a more "principles-based" assessment of liquidity risk, based on a streamlined set of factors; (3) requiring a fund to adopt procedures to address a shortfall in its minimum level of liquidity; and (4) requiring a fund to file a confidential report with the SEC when the fund falls short of its minimum level of liquidity for more than a brief period, or when the fund exceeds a 15% limit on "illiquid" investments. The final rule also modifies the fund board oversight requirements to eliminate the requirement that a board specifically approve a fund's minimum liquidity level.

The Liquidity Rule will significantly affect funds' and service providers' operations and compliance functions, and for a fund with a more concentrated or less liquid portfolio, may affect a fund's investment program. Open-end funds can expect to incur costs, which could be substantial, in implementing or modifying LRMPs and making the required reports and disclosures. To the extent funds rely on third-party service providers to provide liquidity data and analyses, they also will incur the associated expenses. Funds that elect to use swing pricing will face challenges in setting the mechanism for adjusting NAV and communicating this new practice to shareholders. Fund boards will face significant new oversight responsibilities. The SEC also expects to use the information gleaned from fund disclosures when conducting examinations, which may increase potential exposure and liability.

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[4] The SEC has proposed a rule amendment to shorten the standard settlement cycle for most broker-dealer transactions from three business days after the trade (T+3) to two business days after the trade (T+2). See Amendment to Securities Transaction Settlement Cycle, SEC Release No. 34-78962 (Sept. 28, 2016).

[5] Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release, SEC Release No. IC-31835 (Sept. 22, 2015) ("proposal" or "proposed rule"), www.sec.gov/rules/proposed/2015/33-9922.pdf.

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The key elements of the Liquidity Rule and the Swing Pricing Rule are summarized below. A more detailed discussion of the Liquidity Rule follows.

Overview of the New Rules

Liquidity Risk Management Program

Scope: LRMP requirements apply to all open-end funds and open-end ETFs but not to closed-end funds or money market funds. ETFs that primarily redeem in kind ("In-Kind ETFs") are not subject to the classification and liquid investment minimum requirements described below. Unit investment trusts ("UITs") are not subject to the Liquidity Rule's general requirements, but their principal underwriters and depositors must conduct a limited liquidity review.

Requirements:

- **A fund must establish a written liquidity risk management program to assess, manage, and periodically review its liquidity risk** (*i.e.*, the risk that a fund could not meet requests to redeem shares issued by the fund without significant dilution of the remaining investors' interests in the fund), based on specified factors enumerated in the rule, as applicable, that the SEC identifies as a "principles-based" set of requirements.
- **A fund must classify the liquidity of its portfolio investments into one of four categories** (rather than six as proposed), ranging from highly liquid to illiquid. This determination may be done at the asset class level, rather than the position level, as proposed. In-Kind ETFs do not have to classify their investments.
- **A fund must establish a highly liquid investment minimum** and implement policies and procedures for responding to a shortfall. This amount represents the minimum percentage of the fund's net assets that must be invested in highly liquid investments (cash or investments that are reasonably expected to be converted to cash within three business days). Funds that "primarily" hold assets that are highly liquid investments and In-Kind ETFs are excluded from this requirement.
- The rule **codifies an existing 15% limitation on illiquid investments but modifies the definition of "illiquid."** A fund may not acquire illiquid investments if, immediately after the acquisition, the fund would have invested more than 15% of its net assets in illiquid investments. The definition of an "illiquid" asset has been modified from long-standing SEC guidance, and now requires a review of relevant market, trading, and investment-specific considerations when determining whether a holding is illiquid.
- **New Form N-LIQUID** requires a fund to file a confidential report with the SEC, within one business day, if more than 15% of its net assets are, or become, illiquid, or if it breaches the highly liquid investment minimum for more than seven consecutive calendar days.
- A fund's **board must approve the LRMP and review the adequacy and effectiveness of the program at least annually.** The Adopting Release stresses a board's critical role in overseeing fund operations, while also recognizing a board's delegation of the day-to-day management of a fund to its adviser. A board's role under the Liquidity Rule is more closely aligned to a board's role in approving and overseeing a fund's compliance

program, as the Liquidity Rule eliminates certain of the more specific and detailed board approval requirements that were included in the rule proposal.

Compliance Date: Most investment companies (*i.e.*, those part of a fund group with more than $1 billion in assets under management) must comply with the LRMP requirements by December 1, 2018.[6] Companies with less than $1 billion have until June 1, 2019.

Disclosure and Reporting

Scope: All open-end funds and ETFs, but not closed-end funds. Certain disclosure items will not apply to In-Kind ETFs. Although money market funds are excluded from the scope of the Liquidity Rule, they will be subject to the amendments to Form N-1A and Form N-CEN.

Requirements:

- Amendments to Form N-1A require a fund to describe its procedures for redeeming fund shares, the number of days in which the fund typically expects to pay redemption proceeds, the methods for meeting redemption requests, and its use of swing pricing if the fund chooses to use it.
- Amendments to Form N-PORT require a fund to report the aggregated percentage of its portfolio in each of the four classification categories, position-level liquidity classification data, and information regarding a fund's highly liquid investment minimum. In a modification from the proposed rule, only a portion of this information will be disclosed to the public on a quarterly basis.
- Amendments to Form N-CEN require a fund to disclose use of lines of credit, interfund borrowing and lending, and swing pricing. An In-Kind ETF would use this form to indicate its status as such.

Compliance Date: The compliance date for the Form N-1A amendments is June 1, 2017. Most funds (*i.e.*, those in fund groups with more than $1 billion in assets under management) must comply with N-PORT and N-CEN requirements by December 1, 2018. Smaller entities have until June 1, 2019, to comply with Form N-PORT and N-CEN requirements. Please see Appendix A for a summary chart of the new disclosure requirements.

Optional Swing Pricing

Scope: Swing pricing is available to open-end funds, but not to money market funds or ETFs.

Requirements:

- Swing pricing permits a fund to adjust its NAV up or down by a specified amount, the "swing factor," when net purchases or redemptions exceed a specified percentage of the fund's NAV, the "swing threshold." Funds' policies and procedures must specify the process for determining the swing threshold and the swing factor. Policies must also disclose the swing factor limit, which may not exceed 2% of NAV per share.

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[6] Larger entities are funds that, together with other investment companies in the same "group of related investment companies," have net assets of $1 billion or more as of the end of the most recent fiscal year.

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- A fund's board must approve the fund's swing pricing policies and procedures, and periodically review the policy's effectiveness.

Compliance Date: The SEC delayed the effective date of this rule until 24 months after publication in the Federal Register, at which time funds may begin relying on the rule.

Assessing, Managing, And Reviewing Liquidity Risk

The Liquidity Rule requires open-end management investment companies to establish a written LRMP.[7] The Adopting Release states that the majority of commenters supported the initiative to require a formal, written LRMP, while also noting that commenters objected to various aspects of the proposal and suggested modifications. For example, commenters disagreed on the best way to implement an LRMP and whether funds with traditionally more liquid strategies or larger asset sizes should be required to implement an LRMP at all. The LRMP must include assessment, management, and periodic (at least annual) review of a fund's liquidity risk, based on specified factors. The SEC changed certain elements of the proposal, including the definition of liquidity risk and the factors to be considered in a liquidity risk assessment, as described below. In general, the SEC describes the final rule as having a more "principles-based" approach and emphasizes that each fund may develop and adopt procedures tailored as appropriate to reflect the fund's particular facts and circumstances.

The Definition of Liquidity Risk

Definition of Liquidity Risk	
Proposed Rule 22e-4(a)(7)	Adopted Rule 22e-4(a)(11)
[T]he risk that a fund could not meet requests to redeem shares issued by the fund that are expected under normal conditions, or are reasonably foreseeable under stressed conditions, without materially affecting the fund's NAV	[T]he risk that a fund could not meet requests to redeem shares issued by the fund <u>without significant dilution of remaining investors' interests in the fund</u>

The definition of "liquidity risk" removes the proposed rule's requirement that a fund assess the risk that it could not meet redemptions "without materially affecting the fund's net asset value." The Adopting Release notes that commenters objected to the proposed rule's inclusion of the NAV impact standard, stating that many factors impact a fund's NAV, not only transaction activity. The SEC agreed that it may be difficult to calculate the impact that a transaction has on an investment's price. The Adopting Release states that the final definition instead emphasizes the relationship between liquidity and sale price by focusing on meeting investor redemptions without dilution. The reference to "reasonably foreseeable stressed conditions" does not appear in the final rule, but is retained in the first two liquidity risk assessment factors discussed below.

[7] Rule 22e-4 does not apply to money market funds and closed end funds and generally does not apply to UITs. Adopting Release at 1, 53–54.

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Factors to Include in Assessment of Fund Liquidity Risk

Liquidity Risk Factors for Risk Assessment	
Proposed Rule 22e-4(b)(2)(iii)	Adopted Rule 22e-4(b)(1)(i)
Assess and periodically review the fund's liquidity risk, considering the fund's:	Each fund and In-Kind ETF must assess, manage, and periodically review (with such review occurring no less frequently than annually) its liquidity risk, which must include consideration of the following factors, as applicable:
(B) Investment strategy and liquidity of portfolio assets; (C) Use of borrowings and derivatives for investment purposes; and	(A) [The fund's] investment strategy and liquidity of portfolio investments during both normal and reasonably foreseeable stressed conditions, including whether the investment strategy is appropriate for an open-end fund, the extent to which the strategy involves a relatively concentrated portfolio or large positions in particular issuers, and the use of borrowings for investment purposes and derivatives;
(A) Short-term and long-term cash flow projections, taking into account the following considerations: • Size, frequency, and volatility of historical purchases and redemptions of fund shares during normal and stressed periods; • The fund's redemption policies; • The fund's shareholder ownership concentration; • The fund's distribution channels; and • The degree of certainty associated with the fund's short-term and long-term cash flow projections;	(B) Short-term and long-term cash flow projections during both normal and reasonably foreseeable stressed conditions;
(D) Holdings of cash and cash equivalents, as well as borrowing arrangements and other funding sources	(C) Holdings of cash and cash equivalents, as well as borrowing arrangements and other funding sources;
Not applicable	(D) For an ETF: (i) The relationship between the ETF's portfolio liquidity and the way in which, and the prices and spreads at which, ETF shares trade, including, the efficiency of the arbitrage function and the level of active participation by market participants (including authorized participants); and (ii) The effect of the composition of baskets on the overall liquidity of the ETF's portfolio

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Factor One: Investment Strategy

In the Adopting Release, the SEC agrees with commenters that some of the proposed factors may not be applicable to certain funds or types of funds, and thus the final rule instructs funds to consider the specified factors "as applicable." The Adopting Release states that the aim is to simplify and streamline the assessment and factors to be considered and notes that the list of factors is not exhaustive. For example, "if a fund elects to conduct stress testing to determine whether it has sufficient liquid investments to cover different levels of redemptions, a fund may wish to incorporate the results of this stress testing into its liquidity risk and management."

The SEC modified the final rule to require a fund to consider whether its investment strategy is appropriate for an open-end fund. As an example, the Adopting Release notes that it may not be appropriate to structure a fund that primarily holds securities with settlement periods beyond seven days as an open-end fund, because the fund may not be able to meet redemptions within seven days unless it has other sources of liquidity.[8] In addition, the SEC modified the final rule to clarify that consideration of a fund's investment strategy must include an evaluation of whether the strategy involves a relatively concentrated portfolio or large positions in particular issuers. The SEC notes that commenter concerns and recent events, particularly the suspension of redemptions by Third Avenue Focused Credit Fund, led to this modification.[9] The Adopting Release notes that a less diversified fund or a fund holding large portions of a particular issue may have an increased liquidity risk because it may have fewer options for sale and could be compelled to transact in unfavorable markets.

The final rule provides that each of the elements contemplated in the first liquidity risk factor relating to a fund's investment strategy and portfolio liquidity must be considered during both normal and reasonably foreseeable stressed conditions. As a part of this review, the Adopting Release notes that funds should consider historical experience, but should recognize that this experience may not be indicative of future outcomes. The Adopting Release also notes that stressed conditions, including "stresses originating outside of market stresses," likely means different scenarios for different funds.

Factor Two: Cash Flow Projections

The final rule also requires a fund, as part of assessing and managing its liquidity risk, to consider its short-term and long-term cash flow projections during normal and reasonably foreseeable stressed conditions. The Adopting Release notes that review during normal and stressed conditions is necessary to obtain a complete picture of how cash flows may affect a fund's liquidity risk. The proposed rule included five separate considerations, as noted in the chart above, related to a fund's cash flow projections, but the final rule does not enumerate any specific considerations. The SEC states that these five considerations should be viewed as guidance in evaluating cash flow.

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[8] The Adopting Release also provides the example that a fund that is unable to reduce its illiquid investment holdings to or below 15% within the redemption obligation time period may not be suited to operate as an open-end fund.

[9] Soon after the SEC proposed the Liquidity Rule, Third Avenue Focused Credit Fund, a nondiversified open-end fund, obtained exemptive relief from the SEC to suspend shareholder redemptions ahead of a liquidation of the fund, after a period of heavy redemptions and a reduction in the liquidity of its portfolio securities.

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Factor Three: Holdings of Cash and Cash Equivalents

The text of this factor was adopted as proposed. The SEC notes in the Adopting Release that many commenters stated that maintaining significant cash and cash equivalent holdings is not necessarily appropriate for all funds and may not necessarily entirely mitigate liquidity risk as a stand-alone tool. The SEC agreed with commenters, but notes that holding cash and cash equivalents can be a valuable liquidity risk management tool since such holdings tend to remain very liquid under nearly all market conditions. In response to other comments, the Adopting Release notes that borrowing and other funding arrangements can help a fund meet redemption requests, but that a fund should consider the risks and benefits of borrowing and funding arrangements in its LRMP. The SEC makes certain suggestions for this consideration, including: the terms of a credit facility (including whether it is committed or uncommitted), as well as the financial health of the institution providing the facility and whether it is shared among a fund family; and the terms of any interfund lending agreement.

Additional Liquidity Risk Factors for ETFs

The Liquidity Rule also requires all ETFs[10] to consider, in assessing liquidity risk: (1) the relationship between the ETF's portfolio liquidity and the efficiency of the arbitrage function; and (2) the effect of the composition of creation and redemption baskets on the overall liquidity of the ETF's portfolio. The Adopting Release states that if an ETF has a significant amount of illiquid securities in its portfolio, the arbitrage function may fail to operate efficiently, because market participants may find it more difficult to evaluate arbitrage opportunities (due to challenges in pricing, trading, and hedging their exposure to the ETF). This failure could result in investors' buying and selling ETF shares at prices that are not at or close to the NAV per share of the ETF, raising concerns regarding whether all fund shareholders (authorized participants and retail investors) are being treated equitably. The Adopting Release further states that the composition of an ETF's creation and redemption baskets can affect the liquidity of its portfolio, noting, "for example, [that] an ETF whose basket does not reflect a *pro rata* share of the fund's portfolio may alter the liquidity profile of the ETF's portfolio and may adversely affect the fund's future ability to meet cash redemptions or mitigate shareholder dilution."

Frequency of Review of Liquidity Risk

Frequency of Review of Liquidity Risk	
Proposed Rule 22e-4(b)(2)(iii)	Adopted Rule 22e-4(b)(1)(i)
Periodic review of liquidity risk	Periodic review of liquidity risk (<u>no less frequently than annually</u>)

In response to comments recommending that the rule provide a baseline standard for the frequency of reviewing a fund's liquidity risk, the SEC clarifies in the final rule that periodic review means no less frequently than annually. The Adopting Release states that the

[10] UITs, including ETFs structured as UITs, will not be subject to a majority of the LRMP requirements.

change aligns this requirement with a fund's annual review of its highly liquid investment minimum and with the annual board reporting requirement.

Classifying the Liquidity of a Fund's Investments

The Liquidity Rule requires a fund[11] to classify the liquidity of each portfolio investment, including derivatives, into one of four liquidity "buckets," based on the number of days in which the fund *reasonably expects* the investment to be convertible to cash (or sold or disposed of, in the case of the third or fourth buckets) in *current market conditions* without significantly changing the market value of the investment. A fund must take into account relevant market, trading, and investment-specific considerations when classifying its investments. As discussed below, this classification may be completed, at least as a starting point, at the asset level rather than the individual position level. The Adopting Release states that a classification framework based on a days-to-cash or days-to-sale determination provides an effective, uniform methodology for funds' liquidity assessment procedures and a basis for "reasonably comparable reporting" to the SEC about funds' liquidity profiles.

Categories of Liquidity Classification

Proposed Rule 22e-4(b)(2)(i) (six buckets ranging from 1 to 30 days)	Adopted Rule 22e-4(b)(1)(ii) (four buckets ranging from 1 to 7 days)
(A) Convertible to cash within 1 business day (B) Convertible to cash within 2–3 business days (C) Convertible to cash within 4–7 calendar days (D) Convertible to cash within 8–15 calendar days (E) Convertible to cash within 16–30 calendar days (F) Convertible to cash in more than 30 calendar days	22e-4(a)(6). Highly Liquid Investments ($ ≤ 3): includes cash and investments convertible into cash[12] in 3 business days or less without the conversion to cash significantly changing the market value of the investment 22e-4(a)(12). Moderately Liquid Investments (3 < $ ≤ 7): an investment convertible into cash in more than three calendar days but in seven calendar days or less without the conversion to cash significantly changing the market value of the investment 22e-4(a)(10). Less Liquid Investments (sold ≤ 7, settlement > 7): an investment able to be sold or disposed of in seven calendar days or less without the sale or disposition significantly changing the market value of the investment, but where the sale is reasonably expected to settle in more than seven calendar days 22e-4(a)(8). Illiquid Investments (sold > 7): an investment that cannot be sold or disposed of in seven calendar days or less without the sale or disposition significantly changing the market value of the investment

In the final rule, the SEC reduced the number of liquidity categories from six to four. In response to comments, the SEC agreed that the proposed six-category system could lead to unintended negative consequences, such as projections too far in the future, overly subjective projections about asset liquidity, heightened variability between funds' liquidity

[11] The classification requirement does not apply to In-Kind ETFs.

[12] Convertible to cash means that the investment can be sold, with the sale settled. Adopting Release at 90.

assessments, undue reliance on third-party vendors, and an unclear materiality standard that may be impractical to apply.

Highly Liquid Investments

The highly liquid investments category includes cash and investments convertible to cash in three business days or less. It is the only category that utilizes business days, rather than calendar days.[13] The Adopting Release states that during a short time frame, calendar days can be unworkable, such as during holidays and weekends when trading does not occur. The other three categories instead look to the number of calendar days. The Adopting Release notes that this is largely to tie the time frames of these categories to the seven-calendar-day period in which funds are required to pay redeeming shareholders. The Adopting Release further states that "a fund could determine that a broad variety of investments within different asset classes could be classified as highly liquid investments, depending on facts and circumstances."[14]

Moderately Liquid Investments and Less Liquid Investments

The distinguishing factor between the "moderately liquid" investments category and the "less liquid" investments category is the settlement period. While the "moderately liquid" category includes investments that can be converted to cash in a time frame that would permit a fund to pay redeeming investors within the mandated seven days, the "less liquid" category focuses on investments whose sale cannot be settled within the seven-day time frame. As an example of a less liquid investment, the Adopting Release cites foreign securities and U.S. bank loan participations as investments with historically longer settlement periods. The Adopting Release notes that the level of a fund's holdings in "less liquid" investments would be relevant in assessing whether the fund's strategy is appropriate for an open-end fund, and in determining its highly liquid investment minimum.

Illiquid Investments

Unlike the "less liquid" and "moderately liquid" categories, the "illiquid investments" category reflects only the period for selling (or otherwise disposing of) an investment and does not also consider settlement timing. The final rule also harmonizes the definition of an "illiquid" investment both for purposes of the liquidity classification and for purposes of determining the overall limit (15%) that a fund may invest in illiquid assets. In doing so, the SEC withdrew existing guidance on identifying illiquid assets[15] and replaced it with a new definition of an illiquid investment. The result is that funds must now take into account

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[13] The Liquidity Rule states that "if an investment could be viewed as either a highly liquid investment or a moderately liquid investment, because the period to convert the investment to cash depends on the calendar or business day convention used, the fund should classify the investment as a highly liquid investment."

[14] The SEC cautions that, when classifying ETF shares, funds should assess the liquidity characteristics of the underlying securities as well as the characteristics of the ETF itself because "[t]he liquidity of an ETF, particularly in times of declining market liquidity, is limited by the liquidity of the market for the ETF's underlying securities…."

[15] Previous SEC guidance defined an illiquid asset as, "an asset which may not be sold or disposed of in the ordinary course of business within seven days at approximately the value at which the mutual fund has valued the investment on its books." Revisions of Guidelines to Form N-1A, Investment Company Act Release No. 18612 (Mar. 12, 1992) [57 FR 9828 (Mar. 20, 1992)].

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relevant market, trading, and investment-specific considerations, as well as market depth, when determining whether a portfolio holding is illiquid. The Adopting Release recognizes that this new definition of an illiquid investment could result in a fund's determining that a greater percentage of its holdings are illiquid under the Liquidity Rule than under the prior guidelines. The Adopting Release further states that "[i]n extreme circumstances, this—in combination with the limitation on funds' illiquid investment holdings to 15% of its net assets….could cause certain funds to have to modify their investment strategies or reconsider their structure as open-end funds."

Liquidity Classification Factors

Factors to Consider in Liquidity Classification	
Proposed Rule 22e-4(b)(2)(ii)	Adopted Rule 22e-4(b)(1)(ii)
(A) existence of an active market for the asset, including whether the asset is listed on an exchange, as well as the number, diversity, and quality of market participants; (B) frequency of trades or quotes for the asset and average daily trading volume of the asset (regardless of whether the asset is a security traded on an exchange); (C) volatility of trading prices for the asset; (D) bid-ask spreads for the asset; (E) whether the asset has a relatively standardized and simple structure; (F) for fixed income securities, maturity and date of issue; (G) restrictions on trading of the asset and limitations on transfer of the asset; (H) the size of the fund's position in the asset relative to the asset's average daily trading volume and, as applicable, the number of units of the asset outstanding; and (I) relationship of the asset to another portfolio asset	<u>Relevant market, trading, and investment-specific considerations</u>

The Liquidity Rule requires a fund to use "information obtained after reasonable inquiry and taking into account relevant market, trading and investment-specific considerations" to classify each of the fund's portfolio investments. Although the final rule separately identifies a handful of specific required considerations, as discussed in more detail below, the SEC removed the enumerated list of nine separate factors that a fund would be required to consider in classifying and reviewing the liquidity of each portfolio investment.

The Adopting Release states that most commenters opposed codification of the nine factors on the basis that the factors were overly burdensome and not relevant to all asset types. Instead, the SEC adopted a "principles-based requirement" for funds to consider relevant market, trading and investment-specific considerations.[16] The Adopting Release states that while not meant to be a "check-the-box" list, the proposed nine factors are useful and relevant to the liquidity classification process. While the final rule does not codify these factors, the SEC stresses that the factors could help funds in evaluating relevant market, trading, and investment-specific considerations. Consequently, the Adopting Release includes guidance on many of the proposed classification factors.

As a practical matter, the Adopting Release notes that a fund may appropriately use data from third-party service providers to inform or supplement its liquidity assessment of an asset class or specific investment, but suggests that a fund's liquidity program administrator(s) review the quality of any data received, as well as the particular methodologies used and metrics analyzed by the service provider.

Each of the four liquidity classification "buckets" incorporates a value impact standard and the consideration of current market conditions. The SEC also modified the final rule to permit a fund to classify investments by asset class, and to require a fund to consider market depth in classifying investments. A fund must also take into account certain considerations for highly liquid investments that are segregated to cover derivatives transactions. Each of these elements is further discussed below.

Value Impact Standard

Value Impact Standard Within the Definitions of Liquidity Classifications	
Proposed Rule 22e-4(b)(2)(i)	Adopted Rule 22e-4(a)(6), (8), (10), and (12)
[Convertible to cash] at a price that does not materially affect the value of that asset immediately prior to sale	[W]ithout the conversion to cash (or sale or disposition) <u>significantly changing the market value</u> of the investment

The classification categories in the Liquidity Rule, like the proposed rule, contemplate a "value impact" standard; that is, they require a determination that an asset could be converted to cash or sold in current market conditions "without significantly changing [its] market value." The value impact standard as proposed—that an asset could be convertible to cash "at a price that does not materially affect the value"—was opposed by commenters who noted that it was difficult to separate the market impact on a fund's trades in an individual asset from other reasons that an asset's price could move, particularly in dynamic markets. The Adopting Release notes that:

> "funds will be less likely to interpret *significant changes* in market value as capturing very small movements in price, and thus this change should address commenters' concern that the proposal would create a value impact standard that is impractical to apply because any sale of an investment could affect its market value to some degree."[17]

[16] The SEC staff noted that a fund must look at more than asset class or restrictions on transfer and must include market information and other relevant factors in its consideration.

[17] In the Adopting Release, the SEC expressed belief that the word "significant" more effectively conveys than "materially" the idea that the definition is "not meant to reference slight NAV movements, while…better focusing the rule on the level of dilution that would harm remaining investors' interests…" Adopting Release at 61.

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The SEC also clarifies that the value impact standard does not require a fund to incorporate general market movements in liquidity determinations. Rather, the determination should be based on reasonable expectations, in current market conditions, of the market value impact of a hypothetical sale.

Current Market Conditions

Considering Current Market Conditions When Determining Liquidity Classifications	
Proposed Rule 22e-4(b)(2)(i)	Adopted Rule 22e-4(a)(6), (8), (10), and (12)
Not applicable (but implied in the requirement to "engage in an ongoing review" of the liquidity classifications)	[A]ny investment that the fund reasonably expects to be convertible into cash [or able to be sold or disposed of] in current market conditions

The Liquidity Rule requires a fund to consider current market conditions in determining each investment's liquidity classification. The Adopting Release states that this consideration was implied in the proposed rule, which would have required ongoing review of the liquidity classifications. Each liquidity classification should be based on a fund's "reasonable expectations in current market conditions." The Adopting Release states that limiting the assessment to current market conditions, as opposed to foreseeable stressed conditions, may increase consistency among different funds' liquidity determinations, while recognizing that funds' liquidity classifications for similar assets may vary due to different assumptions, facts, and circumstances. By contrast, the Liquidity Rule does require a fund to consider reasonably foreseeable stressed conditions as part of the liquidity risk assessment and management requirements in a fund's LRMP.

Classification Based on Asset Class

Classification Based on Asset Class	
Proposed Rule 22e-4(b)(2)(i)	Adopted Rule 22e-4(b)(1)(ii)(A)
Each position in a portfolio (or portion of a position) must be classified individually	Portfolio investments may be classified according to asset class, subject to exceptions when a particular investment's liquidity characteristics differ significantly from its asset class

Unlike the proposed rule, which required every portfolio position (or portion of a position) to be classified separately, the final rule generally permits a fund to, "as a starting point, classify the liquidity of its portfolio investments according to their asset class." However, a fund is "required to 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 that investment as compared to the fund's other portfolio holdings within that asset class."[18] The Liquidity

[18] As an example, "a fund could decide that high credit quality corporate bonds generally fall into a particular liquidity category, but if the fund or its adviser has information that certain bonds' bid-ask spreads are significantly wider or more volatile than those of their peers, it would be required under Rule 22e-4 to separately assess these bonds and potentially classify them into a less-liquid category…." Adopting Release at 133–34. As another example, the Adopting Release notes that if an adviser is aware of adverse events impacting the issuer of a particular large-capitalization equity security,

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Rule does not specify how a fund or its adviser should identify such an outlying investment, but the Adopting Release states that "reasonably designed policies and procedures would likely include specifying the sources of inputs that inform [a fund's] exception processes (for example, inputs from the fund's portfolio management, risk management, and/or trading functions), as well as particular variables that could affect the fund's classification of certain investments." Commenters emphasized that classification by asset class has practical, operational, and conceptual benefits and reduces the burden of classification.

The Adopting Release cautions that it is inappropriate to use very general asset class categories, such as "equities," "fixed income," and "other," for this purpose. It also states that some asset classes, such as those including bespoke complex derivatives or complex structured securities, may nevertheless require individual classification because the component investments exhibit a wide range of liquidity characteristics. A fund's procedures should contemplate periodic updating of the "default" liquidity classifications for asset classes based on relevant market, trading, and investment-specific considerations, as warranted.

Required Procedures for Considering Market Depth

Consideration of Market Depth	
Proposed Rule 22e-4(b)(2)(i)	Adopted Rule 22e-4(b)(1)(ii)(B)
Classify and engage in an ongoing review of each of the fund's positions in a portfolio asset (or portions of a position in a particular asset) based on the following categories of number of days in which it is determined…	In classifying and reviewing its portfolio investments or asset classes (as applicable), the fund must determine whether trading varying portions of a position in a particular portfolio investment or asset class, in sizes that the fund would reasonably anticipate trading, is reasonably expected to significantly affect its liquidity, and if so, the fund must take this determination into account when classifying the liquidity of that investment or asset class

The proposed rule required a fund to consider the length of time it would take to convert an entire position to cash and required the fund to adjust the liquidity of portions of the investment based on this determination if it anticipated that the liquidity would change as the fund unwound those portions. Under the final rule, a fund must consider the size of a particular investment that it would reasonably anticipate trading and whether the size of those trades could affect the investment's liquidity. If the fund determines that a downward adjustment in the liquidity classification of the investment is appropriate, that new classification would apply to the entirety of the fund's position in that investment. The Adopting Release notes the SEC's intent to make this requirement less burdensome on funds, while responding to commenters' concerns. This approach could result in a lower liquidity classification for an investment than may be warranted by other positions in that investment. Nonetheless, the SEC believes this approach is an improvement over the proposed rule because it allows a fund to more realistically assess the liquidity of its portfolio investments, since it is based on a fund's reasonable trading expectations, rather than unwinding an entire investment.

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this holding may need to be categorized separately from the other investments included in the large-capitalization equity asset class. Adopting Release at 133.

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Classification Issues Related to Derivatives

Classification of Derivatives	
Proposed Rule 22e-4(b)(2)(ii)(I)	Adopted Rule 22e-4(b)(1)(ii)(C)
Consider the relationship of an asset to another portfolio asset	For derivatives transactions that a fund has classified as one of the three less liquid categories, the fund must identify the percentage of its highly liquid investments that it has segregated to cover, or pledged to satisfy margin requirements in connection with, derivatives transactions

The final rule requires a fund to classify derivative instruments in the same manner it classifies other investments. In addition, for derivatives transactions that a fund has classified in one of the three less liquid categories,[19] the fund must identify the percentage of its highly liquid investments that it has segregated to cover, or pledged to satisfy margin requirements in connection with, derivatives transactions in each of those categories. These percentages must be disclosed on Form N-PORT to permit the SEC to understand the portion of a fund's highly liquid investment minimum that is "composed of encumbered assets" and to alert the public that a portion of a fund's highly liquid investments may not be immediately available for redemptions. This requirement replaces the broader proposed rule requirement to consider the relationship of one asset to another portfolio asset. It also requires all derivatives to be classified, regardless of whether they are classified as assets or liabilities. The Adopting Release states that as with all other classifications, a fund should consider all relevant guidance factors to assist with classifying derivatives.

Frequency of Review of Liquidity Classifications

Review of Liquidity Classifications	
Proposed Rule 22e-4(b)(2)	Adopted Rule 22e-4(b)(1)
Review liquidity classifications on an <u>ongoing basis</u>, at least monthly in connection with N-PORT reporting	Review liquidity classifications <u>at least monthly</u> in connection with N-PORT reporting

The Liquidity Rule requires a fund to review its portfolio classifications at least monthly in connection with its required monthly Form N-PORT filing that discloses the liquidity classification of each portfolio investment to the SEC. A fund must review its classifications 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 proposed rule would have required a fund to consider its liquidity classifications on an "ongoing" basis, which commenters argued was unclear and potentially burdensome. The Adopting Release clarifies that there is no expectation of a constant reassessment of liquidity.

[19] Calculated as of the time period in which the fund reasonably expects to exit a transaction. Adopting Release at 151.

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The Highly Liquid Investment Minimum

Establishing the Minimum

Establishing the Minimum	
Proposed Rule 22e-4(b)(2)(iv)	Adopted Rule 22e-4(b)(1)(iii)(A)
(A) Establish a "three-day liquid asset minimum," which is the percentage of the fund's net assets to be invested in assets "convertible into cash within three business days at a price that does not materially affect the value of that asset immediately prior to sale"	22e-4(a)(7): Establish a "highly liquid investment minimum," which is the percentage of the fund's net assets that are investments convertible into cash in three business days without significantly changing the market value of the investment
(A) In determining its minimum, a fund must consider factors specified in the rule	*(1)* In determining its minimum, a fund must consider factors set forth in the rule, but only as applicable
(A) A fund must consider risk factors for both normal and stressed conditions	*(1)* A fund must consider certain liquidity risk factors for both normal and stressed conditions, but only stressed conditions that are reasonably foreseeable during the period until the next review of the minimum
(B) Periodically review, no less frequently than semiannually, the adequacy of the fund's three-day liquid asset minimum	*(2)* Periodically review, no less frequently than annually, the highly liquid investment minimum
22e-4(b)(3)(i): A fund's board must approve the three-day liquid asset minimum	A fund's board need not approve the fund's minimum[20]
22e-4(a)(5): Applicable to all open-end funds	22e-4(b)(1)(iii)(A) and 22e-4(a)(5): In-Kind ETFs and funds whose portfolio assets consist "primarily" of highly liquid investments are exempt from the highly liquid investment minimum requirement

The Liquidity Rule requires open-end funds (but not In-Kind ETFs) to establish a highly liquid investment minimum, which is the percentage of net assets invested in highly liquid investments (*i.e.,* cash or investments that are reasonably expected to be converted into cash within three business days without significantly changing the market value of the investment). This fund-specific minimum must be determined based on the factors a fund uses to assess its liquidity risk.[21] The Adopting Release states that although this requirement alone may not be sufficient for funds to manage liquidity under all market conditions, together with the other LRMP requirements, it is a "central tool to help put a fund in a solid position to meet redemption requests." A fund may consider only its investments that are assets when determining whether it is in compliance with its liquidity minimum.

The final rule differs from the proposed rule in several ways. In-Kind ETFs and funds whose portfolio assets consist "primarily" of highly liquid investments are not required to establish a highly liquid investment minimum. While a "primarily highly liquid fund" is a term not defined in the final rule, the Adopting Release states that, if a fund held less than 50% of its assets in

[20] However, *see infra* footnote 23.

[21] These risk factors include, as applicable, investment strategy and portfolio liquidity during both normal and stressed conditions, short-term and long-term cash flow projections (and the degree of certainty associated therewith), and holdings of cash and cash equivalents. A fund must maintain a written record regarding its determination of its liquidity minimum, including an assessment of each of the applicable factors.

highly liquid investments, it would be unlikely to qualify as "primarily" holding assets that are highly liquid investments. If a fund qualifies for this exclusion, it must explain in its LRMP how it determined that it primarily holds highly liquid assets.[22]

As in the proposal, a fund must consider both normal and reasonably foreseeable stressed conditions in determining its liquidity minimum. However, the final rule specifies that a fund need only consider stressed conditions that are reasonably foreseeable *during the period until the next review of the minimum*, but no longer than a year. The Adopting Release states that this modification responds to commenters' concerns about the ambiguity in the length of time over which a fund should forecast the effect of stressed conditions and that the proposed requirement may suggest that a fund should hold a high level of cash or other highly liquid assets at all times.

Further, a fund's board is no longer required, except in limited circumstances, to approve the fund's highly liquid investment minimum as proposed.[23] A fund must make reports to its board when there is a shortfall in the minimum, as discussed below, and a discussion of the fund's minimum must be included in the annual report to the board on the effectiveness of the fund's LRMP.

Shortfall Policies

Shortfall Policies	
Proposed Rule 22e-4(b)(2)(iv)	Adopted Rule 22e-4(b)(1)(iii)(A)*(3)*
Not applicable	A fund must adopt and implement policies and procedures for responding to a shortfall. The policies must require a fund to report a shortfall to the board no later than the next regularly scheduled board meeting; if a shortfall lasts more than seven consecutive calendar days, the policies must require a fund to report to its board and the SEC within one business day
(C) A fund will "[n]ot acquire any less liquid asset if, immediately after the acquisition, the fund would have invested less than its three-day liquid asset minimum in three-day liquid assets"	During a shortfall, a fund may acquire investments that are not highly liquid
Not applicable	Rule 30b1-10: Report to SEC using Form N-LIQUID when a fund experiences a shortfall for more than seven consecutive calendar days

The Liquidity Rule requires a fund to implement policies and procedures to address a "shortfall," or a dip below its highly liquid investment minimum. These policies must include reporting to the board on any brief shortfalls no later than the next regular board meeting. If the shortfall lasts more than seven consecutive calendar days, a fund must report to its

[22] For purposes of determining whether a fund primarily holds assets that are highly liquid investments, a fund must exclude from its calculations investments that it has set aside to cover derivatives transactions or pledged to satisfy margin requirements in connection with those derivatives transactions.

[23] If a fund's highly liquid investments are below the fund's determined minimum level, the minimum can only be changed with board approval.

board, and submit Form N-LIQUID to the SEC, within one business day. The report to the board must include an explanation of the cause of the shortfall, extent of the shortfall, and plans to restore the fund's minimum within a reasonable period of time.

In a change from the proposal, the final rule allows a fund to acquire non-highly liquid investments, even during a period of shortfall. Under the proposed rule, a fund would have been prohibited from acquiring any assets other than a "three-day liquid asset" if, after acquisition, the fund would hold fewer three-day liquid assets than the percentage specified under its minimum. The Adopting Release states that the requirement to adopt shortfall policies and procedures replaces that proposed prohibition in response to commenters' concerns. For example, some commenters noted that the prohibition could have adverse effects, including potentially increasing shareholder redemptions, if shareholders believe a fund may not employ its strategy effectively at certain times due to this prohibition.

In addition to the new Form N-LIQUID, the final rule requires a fund to report monthly to the SEC its highly liquid investment minimum on Form N-PORT. If a fund dips below its minimum during the reporting period, it must also report the number of days it was below the minimum. In response to commenters, the SEC will not disclose this information to the public.

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The 15% Limit on Illiquid Investments

15% Limit on Illiquid Investments	
Proposed Rule 22e-4(b)(2)(iv)(D)	Adopted Rule 22e-4(b)(1)(iv)
"[T]he fund will…[n]ot acquire any 15% standard asset if, immediately after the acquisition, the fund would have invested more than 15% of its [net] assets in 15% standard assets…."	"No fund or In-Kind ETF may acquire any illiquid investment if, immediately after the acquisition, the fund or In-Kind ETF would have invested more than 15% of its net assets in illiquid investments that are assets."
22e-4(a)(4): "15% standard asset" is "an asset that may not be sold or disposed of in the ordinary course of business within seven calendar days at approximately the value ascribed to it by the fund." [24]	22e-4(a)(8): An illiquid investment is an investment not reasonably expected to be "sold or disposed of in current market conditions in seven calendar days or less without the sale or disposition significantly changing the market value of the investment," taking into account relevant market, trading, and investment-specific considerations and considering market depth.
Not applicable	(A) A fund must report an occurrence of illiquid investment holdings exceeding 15% to its board within one business day "with an explanation of the extent and causes of the occurrence, and how the fund plans to bring its illiquid investments that are assets to or below 15% of its net assets…."
Not applicable	(B) "If the amount of the fund's illiquid investments that are assets is still above 15% of its net assets 30 days from the occurrence," then the board "must assess whether the plan presented to it…continues to be in the best interest of the fund or In-Kind ETF."
Not applicable	Rule 30b1-10: Report to SEC using Form N-LIQUID when a fund exceeds the 15% limit, and again when illiquid investments return to 15% or below.

The Liquidity Rule, like the proposal, imposes a 15% "ceiling" limiting the acquisition of assets that cannot be sold or disposed of within seven days. The rule prohibits a fund from purchasing any illiquid investment if, immediately after the acquisition, the fund would have invested more than 15% of its net assets in illiquid investments that are investments with positive values. The limitation on illiquid investments applies to all funds, including In-Kind ETFs.

However, the final rule differs from the proposal in several ways. Under the proposal, a fund's determination of compliance with the 15% limit, which involved identifying "15% standard assets," was separate from its liquidity classification determinations. The final rule harmonizes the "illiquid" definition for both determinations—that is, the same definition of "illiquid" applies for determining compliance with the 15% limit and for classifying assets in

[24] Proposed Rule 22e-4(b)(2)(iv)(D). In this formulation, the fund would not have needed to consider the size of the fund's position in the asset or the number of days to receive the proceeds of the sale or disposition. The Adopting Release clarifies that the proposed definition was intended to refer to "net assets" and not "total assets," despite the text of the proposed rule, which referred to "total assets" in error. Adopting Release at 231, n.748.

the "illiquid assets" bucket. Second, for purposes of the 15% limit, a fund must now take into account relevant market, trading, and investment-specific considerations and consider market depth, when classifying an asset as illiquid.

The 15% illiquid asset limit remains a "time of acquisition" test and not a "maintenance" test; however, the Liquidity Rule imposes new reporting requirements and an obligation to cure if a fund *holds* more than 15% of its net assets in illiquid investments. If a fund breaches the 15% limit, it must notify both its board and the SEC (on confidential Form N-LIQUID) within one business day of the breach. The person(s) administering the LRMP must explain to the fund's board the extent and causes of the occurrence and its plans to bring the fund's illiquid investments to or below 15% of the fund's nets assets within a reasonable period of time. If a fund's illiquid investments remain above the 15% limit after 30 days from the occurrence (and at each consecutive 30-day period thereafter), the board must assess whether the plan previously presented to it continues to be in the best interest of the fund. A fund must disclose the percentage of its holdings in illiquid investments on Form N-PORT. This information is disclosed to the public on a quarterly basis, with a 60-day delay.

The Board's Role in Liquidity Risk Management

The SEC notes in the Adopting Release that "directors, and particularly independent directors, play a critical role in *overseeing* fund operations, although they generally may delegate day-to-day management to a fund's adviser" (emphasis added). The Liquidity Rule requires a fund's board of directors to approve the investment adviser, officer, or officers ("program administrator") who are responsible for administrating the program. It also requires a fund's board of directors to approve the fund's written LRMP. The program administrator is required to provide the board with a written report, at least annually, discussing the adequacy of the fund's LRMP and the effectiveness of its implementation. This report should also discuss any material changes to the LRMP. As discussed elsewhere, the program administrator is required to report to a fund's board within one business day if the fund's holdings of illiquid investments exceed 15% of its net assets or if the fund dips below its highly liquid investment minimum for more than seven consecutive calendar days.

The Adopting Release notes that commenters were concerned that the proposed rule "imposed management responsibilities" on a fund's board of directors and that certain proposed requirements were both "technical and fact-intensive" and required day-to-day judgments. Commenters suggested that the final rule align more closely with the requirements of Rule 38a-1, which governs a fund's compliance program. In response to comments, the final rule no longer requires a fund's board to specifically approve the fund's highly liquid investment minimum, except in limited circumstances, or changes to the LRMP, as originally proposed. The final rule requires a fund's board of directors to approve an increase to a fund's highly liquid investment minimum only if the fund is below its minimum and the program administrator seeks to change it.

The Adopting Release states that the role of a fund's board under the Liquidity Rule is "one of general oversight, and consistent with that obligation we expect that directors will exercise their reasonable business judgment in overseeing the [liquidity risk management] program on behalf of the fund's investors." The Adopting Release further provides that a fund's board may satisfy its obligations with respect to its initial approval of the LRMP by reviewing summaries of the program prepared by the program administrator. The summaries should familiarize the board with the "salient features" of the LRMP and provide a framework of how the program addresses the required assessment of the fund's liquidity risk. The Adopting Release clarifies that neither SEC guidance nor the Liquidity Rule places the responsibility for determining the liquidity of a particular asset on a fund's board.[25]

Additional Guidance on Liquidity Risk Management

Redemptions In-Kind

Redemptions In-Kind	
Proposed Rule 22e-4(b)(2)(iv)(E)	Adopted Rule 22e-4(b)(1)(v)
"Establish policies and procedures regarding redemptions in kind, to the extent that the fund engages in or reserves the right to engage in redemptions in kind."	"A fund that engages in, or reserves the right to engage in, redemptions in kind and any In-Kind ETF must establish policies and procedures regarding how and when it will engage in such redemptions in kind."
These policies and procedures should "address the process for redeeming in kind, as well as the circumstances under which the fund would consider redeeming in kind."[26]	"These policies and procedures generally should address the process for redeeming in kind, as well as the circumstances under which the fund would consider redeeming in kind."[27]
Not applicable	"Well-designed policies and procedures would likely address the particular circumstances in which a fund might employ in-kind redemptions…" and "whether a fund would use in-kind redemptions for all redemption requests or only for requests over a certain size…."[28]
Not applicable	Policies and procedures could also address "the ability of investors to receive in-kind redemptions, potentially including different procedures for different shareholder types."[29]

The Liquidity Rule, like the proposal, requires a fund that engages in, or reserves the right to engage in, in-kind redemptions to implement written policies and procedures regarding in-kind redemptions as part of the management of its liquidity risk. The policies and procedures should address the process for redemptions and the circumstances under which the fund would consider redeeming in kind. The Adopting Release notes that commenters generally agreed that such redemptions are an important liquidity risk management tool, but recognizes that some logistical challenges exist, such as shareholder ability or willingness to receive in-kind redemptions.

The Adopting Release provides guidance regarding certain aspects of the policies and procedures a fund may wish to consider. For example, the Adopting Release notes that a fund may wish to include different procedures for different shareholder types to address the

[25] Instead, the board is responsible for approving the fund's LRMP.

[26] Proposal at 162.

[27] Adopting Release at 239.

[28] Adopting Release at 240–41.

[29] Adopting Release at 241.

ability of investors to receive such redemptions. It also notes that "well-designed policies and procedures would likely address" the specific circumstances in which a fund may employ such redemptions. Such procedures may address how a fund determines which securities to use in such redemptions and the manner in which securities would be redeemed (*e.g.*, pro rata ratio of the fund's holdings versus non-pro rata).

Cross-Trades

The Adopting Release provides guidance regarding funds' reliance on Rule 17a-7 under the 1940 Act to engage in purchase and sale transactions with certain affiliates ("cross-trades"). The Adopting Release recognizes that cross-trades may benefit shareholders, but warns about the significant potential for abuse (*e.g.*, an adviser "dumping" undesirable securities on a fund or transferring desirable securities from a fund to a more favored client). The Adopting Release reminds investment advisers to scrutinize less liquid assets before cross-trading those assets to ensure they satisfy all of the requirements of Rule 17a-7. The Adopting Release also notes that pursuant to Rule 38a-1 under the 1940 Act, a fund's compliance policies and procedures related to Rule 17a-7 should address how the fund meets these requirements with regard to less liquid assets. The Adopting Release recommends that funds consider including in their procedures for cross-trades (1) the sources of readily available market quotations to be used to value the cross-traded assets; (2) criteria for determining whether market quotations are readily available; and (3) criteria for assessing the quality of broker-dealer quotations used in valuing cross-traded assets.

Recordkeeping

The Liquidity Rule requires a fund to maintain a written copy of the policies and procedures adopted as part of its LRMP for five years. A fund must maintain copies of any materials provided to its board of directors in connection with its initial approval of the LRMP, as well as copies of any other reports provided to the board. A fund is also required to keep a written record of how it determined its highly liquid investment minimum and any adjustments thereto. The Adopting Release notes that these requirements were meant to be consistent with a fund's other recordkeeping obligations.

ETFs

The Liquidity Rule includes tailored LRMP requirements for ETFs. As discussed above, in determining its highly liquid investment minimum, ETFs are required to consider certain additional factors, as applicable, such as the relationship between the ETF's liquidity and its trading prices, and the effect of the composition of baskets on overall liquidity. Like other open-end funds, ETFs are required to limit illiquid investments to no more than 15% of net assets.

In contrast, In-Kind ETFs[30] do not have to classify their assets and are not subject to the highly liquid investment minimum. However, they must still implement a tailored LRMP,

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

described in their written policies and procedures. An In-Kind ETF must also report its designation as such on Form N-CEN.[31]

Unit Investment Trusts

The Liquidity Rule does not require unit investment trusts ("UITs") to implement an LRMP. In a change from the proposed rule, the final rule does require a UIT to perform a limited liquidity review. A UIT's principal underwriter or depositor must determine that "the portion of the illiquid investments the UIT holds or will hold at the date of deposit that are assets is consistent with the redeemable nature of the securities it issues." This review would be similar to the process for determining if a fund's holdings are within the 15% limitation on illiquid investments.

Optional Swing Pricing

The SEC also adopted the Swing Pricing Rule on October 13, 2016. The SEC proposed the Swing Pricing Rule together in a single proposal with the Liquidity Rule in 2015, but separated the two for its final vote. While all three commissioners voted to approve the Liquidity Rule, Commissioner Piwowar voted against the Swing Pricing Rule, and it appears the SEC split this part of the rule proposal into a separate proposal for this reason.[32]

The Swing Pricing Rule allows, but does not require, an open-end fund (other than a money market fund or an ETF) to adjust or "swing" its NAV by a specified amount—the "swing factor"—once the level of net purchases into, or net redemptions from, the fund has exceeded a specified percentage of the fund's NAV known as the "swing threshold." During such times, swing pricing is intended to reflect immediately in a fund's NAV the costs associated with shareholders' trading activity in order to pass those costs on to the purchasing and redeeming shareholders. Swing pricing allows a fund to mitigate shareholder dilution that might result from purchases into or redemptions out of a fund, and thus is intended to be another tool to help funds manage liquidity risks.

If a fund chooses to use swing pricing, it must adopt swing pricing policies and procedures, which must set the swing threshold and swing factor. The swing factor may not exceed 2% of the fund's NAV. Fund complexes may choose to apply swing pricing to all, none, or only some of their funds and can establish separate swing thresholds and swing factors for each fund. In a difference from the proposed rule, a particular fund may set multiple swing thresholds linked with multiple swing factors (not to exceed the upper limit).

[31] If an In-Kind ETF were to use more than a *de minimis* amount of cash to meet redemptions, it would not qualify as an In-Kind ETF. But depending on the circumstances, an ETF that delivers cash on only one occasion may be able to conclude that it qualifies as an In-Kind ETF.

[32] Commissioner Piwowar cited two main concerns with the Swing Pricing Rule. He stated his "primary investor protection concern is that swing pricing will be used to conceal from investors the true costs they will incur upon the purchase and sale of their fund shares." Second, he noted that "adopting a swing pricing threshold could open the door to harmful gaming behavior. For example, sophisticated investors could time their purchases and redemptions based on the likelihood that a fund would adjust its NAV." Michael S. Piwowar, *Statement at Open Meeting on Investment Company Liquidity Risk Management Programs, Investment Company Swing Pricing, and Investment Company Reporting Modernization Releases*, U.S. Securities and Exchange Commission (Oct. 13, 2016), https://www.sec.gov/news/statement/piwowar-statement-open-meeting-101316.html.

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Similar to the Liquidity Rule, the Swing Pricing Rule requires a fund's board of directors to designate a swing pricing administrator. The board also must approve swing pricing policies and procedures, including the swing threshold and swing factor upper limit. The board must approve any changes to the swing threshold and swing factor upper limit and review a report on the program at least annually. The SEC eliminated the requirement that a fund board approve all material changes to the swing pricing policies and procedures.

A fund that uses swing pricing must disclose in its prospectus a description of the practice, its impact on the fund's assets, and the swing factor upper limit. However, funds are not required to disclose to the public their swing pricing threshold or swing factor, to discourage market timing and unfair trading.

Funds choosing to implement swing pricing will face operational challenges, as well as challenges in communicating the practice to investors. To use swing pricing, a fund will need to understand daily whether its net flow exceeds the swing threshold. This requires enough information for the fund to estimate its net flow with "high confidence," per the SEC's instructions. Funds will likely incur costs related to obtaining flow information from third parties, such as transfer agents and third-party intermediaries. Further, because swing pricing alters investors' historical understanding that the price of a mutual fund's shares is based on the NAV, which reflects the fund's current assets and liabilities, and because swing pricing is optional, investors may perceive the practice as unfair.

The Swing Pricing Rule becomes effective two years after its publication in the Federal Register, at which time funds may begin relying on the rule. The SEC extended the effective date to two years to provide funds, service providers, and intermediaries with lead time to address operational issues. The SEC also directed its staff to review the market practices associated with the Swing Pricing Rule two years after it becomes effective.

Public and Confidential Disclosures About Liquidity Risk

As part of the final Liquidity Rule, the SEC amended Form N-1A, amended newly adopted Forms N-PORT and N-CEN, and adopted new Form N-LIQUID. In addition to the summaries provided below, please also see Appendix A for a summary of these disclosure and reporting forms as they relate to a fund's LRMP, including the compliance dates for each of these changes.

Form N-1A

The SEC adopted amendments to Form N-1A mostly as proposed, requiring a fund to describe its procedures for redeeming shares, the number of days in which it expects to pay redemption proceeds, and its methods for meeting redemption requests in stressed and non-stressed market conditions. In a change from the proposal, a fund is not required to disclose the timing of redemption proceeds by distribution channel, but must disclose typical payout times based on the payment method chosen by the investor. This disclosure requirement focuses on when the fund expects to make the payment, not when the shareholder should expect to receive the proceeds. These amendments and Regulation S-X amendments also require reporting on swing pricing when applicable, including an explanation of swing pricing usage in the registration statement.

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In a change from the proposal, a fund is not required to file line of credit agreements as exhibits to its registration statement. The Adopting Release notes that commenters expressed concerns that such agreements are lengthy and not user-friendly, and that public disclosure of such agreements may disrupt a fund's negotiating power and unnecessarily expose proprietary information.

Form N-PORT

Form N-PORT is amended to require monthly disclosure to the SEC of a fund's highly liquid investment minimum and individual portfolio classifications. The SEC altered the proposed rule to keep these disclosures confidential. Funds are also required to disclose monthly the aggregate percentages of portfolio investments in each liquidity category and the percentage of a fund's highly liquid assets segregated to cover—or pledged to satisfy margin requirements in connection with—the fund's derivatives transactions. The aggregate percentages and the derivatives-related percentage will be made public 60 days after the end of each fiscal quarter.

Form N-CEN

The SEC adopted, as proposed, required N-CEN reporting on the use of lines of credit, interfund lending and borrowing, swing pricing, and self-identification as an In-Kind ETF. In a change from the proposed rule, a fund that reports a line of credit must distinguish whether each line of credit is committed or uncommitted.

Form N-LIQUID

A major change in the final rule was the addition of the new (nonpublic) N-LIQUID Form, which a fund is required to file when certain liquidity-related events occur. Reportable events are a breach of the 15% limitation on illiquid investments, a subsequent change in holdings to comply with the 15% limitation, and a dip below the highly liquid investment minimum for more than seven consecutive calendar days. Form N-LIQUID must be filed within one business day of the occurrence of a reportable event.

Conclusion

The Liquidity Rule's earliest upcoming compliance date is June 1, 2017, at which time funds must begin disclosing redemption procedures when filing Form N-1A. Most entities will have to comply with the broader LRMP requirements by December 1, 2018. In the meantime, funds will need to consider a variety of issues related to implementation of the rule, including setting up or modifying their internal liquidity risk management programs and identifying resources for providing liquidity data and analysis. In addition, boards of directors should review their new oversight responsibilities under the final rule. K&L Gates is available to answer any specific questions you may have and is prepared to assist you with the Liquidity Rule and related disclosure matters.

Time to Get With the (Liquidity Risk) Program: SEC Issues Liquidity Risk Management Rule for Open-End Funds

Appendix A

Disclosure Forms Applicable to Liquidity Risk Management Program

Form	When to Comply	Who Must Comply	What to Disclose	When to Disclose
N-1A	All initial registration statements and post-effective amendments to effective registration statements on Form N-1A, filed on or after June 1, 2017, must include the required disclosure	Open-end funds Money Market Funds ETFs	Redemption procedure (number of days typically expected to pay proceeds, methods typically used to meet redemption requests) Information on swing pricing, if used	At initial registration and when amending
N-PORT	By December 1, 2018, for larger entities (*i.e.*, larger funds would file their first reports, with data as of December 31, 2018, no later than January 31, 2019) By June 1, 2019, for smaller entities	Open-end funds ETFs, including ETFs organized as UITs (In-Kind ETFs are not subject to the highly liquid investment minimum or the classification requirements) Exempt: Money Market Funds	Highly Liquid Investment Minimum information (remains confidential) Liquidity classification for each portfolio investment among the four categories (remains confidential) Percentage of highly liquid investments segregated to cover, or pledged to satisfy margin requirements in connection with, derivatives transactions that are moderately liquid, less liquid, or illiquid investments (made public quarterly, with a 60-day delay) Aggregate percentage of investments in each of the four categories (made public quarterly, with a 60-day delay)	Monthly
N-CEN	By December 1, 2018, for larger entities By June 1, 2019, for smaller entities	Open-end funds Money Market Funds ETFs UITs	Lines of credit, including whether each line was committed or uncommitted Interfund lending and borrowing Swing pricing information Self-identify as In-Kind ETF	Annually

Time to Get With the (Liquidity Risk) Program: SEC Issues Liquidity Risk Management Rule for Open-End Funds

Form	When to Comply	Who Must Comply	What to Disclose	When to Disclose
N-LIQUID	By December 1, 2018, for larger entities By June 1, 2019, for smaller entities	Open-end funds In-Kind ETFs are exempt from Part D of the form because they are not subject to the highly liquid investment minimum Exempt: Money Market Funds	If the 15% limit on illiquid investments is exceeded: disclose date of breach, current percentage of illiquid investments, and identify the illiquid investments When fund gets back to, or below, the 15% limit following a breach: disclose date of occurrence and current percentage of illiquid investments If dip below highly liquid investment minimum for 7+ consecutive calendar days: disclose date shortfall occurred All N-LIQUID disclosures remain confidential	If the 15% limit on illiquid investments is exceeded, disclose within one business day When fund gets back to, or below, the 15% limit following a breach, disclose within one business day If dip below highly liquid investment minimum lasting 7+ consecutive calendar days, disclose within one business day

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