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MUTUAL FUNDS

Summary of New SEC Requirements for Open-End Fund Liquidity Risk Management



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On October 13, 2016, the U.S. Securities and Exchange Commission (Commission) unanimously adopted new Rule 22e-4 (Liquidity Rule) under the Investment Company Act of 1940 (the 1940 Act) and other regulatory changes that require each open-end fund registered under the 1940 Act, including traditional mutual funds and exchange-traded funds (ETFs) but excluding money market funds (MMFs), to establish a formal liquidity risk management program that must include certain key components. A copy of the Commission’s liquidity risk management program adopting release (Liquidity Program Release) is available here.

This Article summarizes the critical elements of the Liquidity Rule, as well as related guidance and commentary from the Commission set forth in the Liquidity Program Release. Although focused on the final rule-making, this Article also includes brief summaries of certain of the critical changes from the initial rule proposal on September 22, 2015 (Proposal) that help explain the requirements of the final Liquidity Rule.

As a general matter, the Liquidity Rule applies to all open-end funds, other than MMFs. There are certain tailored requirements for ETFs that are designed to recognize and account for ETFs’ unique liquidity-related risks, as discussed below. Unless otherwise specified, references to a “fund” or an “open-end fund” in this Ar-

ticle encompass all registered open-end funds, including all ETFs but excluding MMFs.

Section 1: Liquidity Risk Management

The Liquidity Rule requires each open-end fund to adopt and implement a formal Liquidity Program. As part of its Liquidity Program, a fund is required to:

- assess, manage and review the fund’s “liquidity risk”;
- classify the liquidity of the fund’s portfolio investments into one of four liquidity classifications (referred to herein as “buckets” or “categories”);
- determine a minimum amount of the fund’s net assets that must be invested in “highly liquid investments” that are assets (referred to as the fund’s “HLIM”); and
- limit the fund’s investments in “illiquid investments” that are assets to no more than 15% of the fund’s net assets.

In addition, the Liquidity Program Release includes requirements relating to the use of in-kind redemptions and recordkeeping and guidance on cross-trade transactions. The Liquidity Program Release also provides the Commission’s views regarding the role of a fund’s board, as further discussed below.

Assessment, Management and Review of a Fund's Liquidity Risk

The Liquidity Rule requires each fund to assess, manage and periodically review its "liquidity risk," in light of certain specified factors.

Definition of Liquidity Risk. "Liquidity risk" is defined as "the risk that [a] fund could not meet requests to redeem shares issued by the fund without significant dilution of remaining investors' interests in the fund." This definition of "liquidity risk" focuses on the level of dilution that would harm the interests of remaining fund shareholders, which the Commission believes directly corresponds to the policy concerns underlying the adoption of the Liquidity Rule.

Liquidity Risk Factors. The Liquidity Rule requires that a fund consider a non-exhaustive list of factors in assessing and managing its liquidity risk (Liquidity Risk Factors). In particular, a fund is required to take into account the following factors, as applicable:

- 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, the extent to which the strategy involves a relatively concentrated or large positions in particular issuers, and the use of borrowings for investment purposes and derivatives;

- the fund's short- and long-term cash flow projections during both normal and reasonably foreseeable stressed conditions; and

- the fund's holdings of cash and cash equivalents, as well as borrowing arrangements and other funding sources.

In addition, the Liquidity Rule includes the following two additional factors that an ETF must consider, as applicable, which reflect potential liquidity-related concerns that could arise from the unique structure and operation of ETFs:

- 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

- the effect of the composition of baskets on the overall liquidity of the ETF's portfolio.

The Commission clarified in the Liquidity Program Release that, to the extent any Liquidity Risk Factor is not applicable to a particular fund, that fund will not be required to consider such Liquidity Risk Factor in assessing and managing its liquidity risk. Moreover, the Liquidity Program Release provides that the list of Liquidity Risk Factors is not meant to be exhaustive and a fund may take into account other considerations, and indeed must do so to the extent necessary to adequately assess and manage the fund's liquidity risk.

Periodic Review of Liquidity Risk. In addition to a fund's obligation to initially assess and manage its liquidity risk, the Liquidity Rule imposes a requirement

on each fund to periodically (and no less frequently than annually) review its liquidity risk.

Classifying the Liquidity of a Fund's Portfolio Investments

The Liquidity Rule requires each fund, other than an ETF that qualifies as a so-called "In-Kind ETF" (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") to classify the liquidity of its portfolio investments into one of four liquidity categories. In a significant departure from the Proposal, the Commission adopted a more simplified and consolidated version of the proposed classification scheme, with fewer classification categories (reduced from six to four) based on shorter time projections (reduced from a maximum of 30 days to seven days) and by permitting funds generally to classify portfolio investments by asset class as opposed to on an individual investment-by-investment basis.

Liquidity Classification Categories. The Liquidity Rule requires a fund to classify the liquidity of each of its portfolio investments based on the number of days within which the fund reasonably expects an investment would be convertible to cash (or, in the case of the "less liquid" and "illiquid" buckets, sold or disposed of) in current market conditions without significantly changing the market value of the investment. Specifically, a fund is required to classify each of its portfolio investments into one of the following liquidity buckets:

- **Highly liquid investments** – Cash and any investment reasonably expected to be convertible to cash (the ability to be sold, with the sale settled) in current market conditions in *three business days or less* without the conversion to cash significantly changing the market value of the investment.

- **Moderately liquid investments** – Any investment reasonably expected to be convertible to cash in current market conditions in *more than three calendar days but in seven calendar days or less* without the conversion to cash significantly changing the market value of the investment.

- **Less liquid investments** – Any investment reasonably expected to be sold or disposed of in current market conditions in *seven calendar days or less* without the sale or disposition significantly changing the market value of the investment, but where the sale or disposition is reasonably expected to settle in *more than seven calendar days*.

- **Illiquid investments** – Any investment that may not reasonably be expected to be sold or disposed of in current market conditions in *seven calendar days or less* without the sale or disposition significantly changing the market value of the investment.

A fund's determination in classifying its portfolio investments must be based on information obtained after a "reasonable inquiry," taking into account:

- relevant market, trading and investment-specific considerations; and

■ whether varying portions of a position in a particular portfolio investment (i.e., “market depth”), in sizes that the fund would reasonably anticipate trading, is reasonably expected to significantly affect the liquidity characteristics of that investment.

As adopted, the Liquidity Rule does not include enumerated factors that a fund must evaluate in taking into account relevant market, trading and investment-specific considerations. Rather, the Commission established a “principles-based approach.” In contrast, under the Proposal, a fund would have been required to specifically consider nine separate factors, to the extent applicable, in classifying the liquidity of each portfolio position in a particular asset.

Illiquid Investments. In a departure from the Proposal, the Commission incorporated an “illiquid investment” classification into the broader classification scheme (i.e., the four categories listed in the above chart). By harmonizing the limitations on a fund’s illiquid investments with the general liquidity classification framework, the Commission sought to create consistency in the value impact standards used across the liquidity categories, which otherwise would have been different under the Proposal.

Classification Based on Asset Class. In an important change from the Proposal, the Liquidity Rule generally permits a fund to, as a starting point, classify the liquidity of its portfolio investments according to their asset class (rather than on an investment-by-investment basis). This approach recognizes that many investments within an asset class may be considered interchangeable from a liquidity perspective and it will have the effect of lessening operational burdens associated with the classification requirement.

Importantly, however, this general rule will not apply, and a fund will be required to separately classify any individual investment, if the fund, after reasonably 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 class.

Review of Liquidity Classifications. Under the Liquidity Rule, a fund is required to review its liquidity classifications at least monthly in connection with reporting its liquidity classifications on new Form N-PORT taking into account relevant market, trading and investment-specific considerations.

Highly Liquid Investment Minimum (HLIM)

The Liquidity Rule requires each fund, other than In-Kind ETFs and funds that “primarily” hold highly liquid assets, to determine a minimum amount of the fund’s net assets that must be invested in highly liquid investments that are assets. The Commission believes that the HLIM requirement will increase the likelihood that a fund would be prepared to meet redemption requests without significant dilution of remaining investors’ interests in the fund. According to the Commission, the HLIM is not meant to suggest that a fund should only, or primarily, use its most liquid investments to meet shareholder redemptions.

HLIM Determination. In determining its HLIM, a fund is required to consider the same Liquidity Risk Factors that the fund must consider in assessing, managing and reviewing its liquidity risk. The Commission does not provide a range of what it considers to be an appropriate HLIM, as this is a determination that must be made by each fund based on its particular facts and circumstances. However, the Commission believes that it would be “extremely difficult” for a fund to conclude that an HLIM of zero would be appropriate.

Shortfall Policies and Procedures. A fund is required to adopt specific policies and procedures for responding to a shortfall in the fund’s assets that are highly liquid investments (Shortfall Procedures). In contrast with the Proposal, a fund that falls below its HLIM (HLIM Shortfall) will not be limited to acquiring only highly liquid investments, if acquiring other investments would be consistent with the fund’s Shortfall Procedures. The Liquidity Rule provides flexibility as to the particular Shortfall Procedures a fund may adopt, in recognition that different facts and circumstances could result in different funds taking varying approaches to address a decline in assets that are highly liquid investments.

Periodic Review of HLIM. A fund is required to periodically review, no less frequently than annually, its HLIM. This minimum annual review period correlates with the requirement for a fund to review its liquidity risk at least annually.

Exclusion for Funds Primarily Holding Assets that are Highly Liquid Investments. Under the Liquidity Rule, a fund that “primarily” holds assets that are highly liquid investments is excluded from the requirements to determine and review an HLIM and adopt Shortfall Procedures. Although the Commission does not define “primarily” or list specific types of funds that categorically meet this exclusion, the Commission’s view is that a fund that holds less than 50% of its assets in highly liquid investments would be unlikely to qualify as “primarily” holding assets that are highly liquid investments.

15% Limit on Illiquid Investments

The Liquidity Rule sets a limit on the ability of a fund to acquire “illiquid investments”. Specifically, a fund is prohibited from acquiring any illiquid investment if, immediately after the acquisition, the fund would have invested more than 15% of its net assets in illiquid investments. If a fund’s holdings of illiquid investments exceed 15% of its net assets, a fund would not be required to divest illiquid investments but is prohibited from acquiring illiquid investments while exceeding the 15% limit.

Withdrawal of Long-Standing 15% Commission Guideline. The Commission withdrew its long-standing guideline and related guidance that generally limits a fund from investing more than 15% of its net assets in “illiquid assets,” defined as assets that cannot be sold or disposed of in the ordinary course of business within seven days. The Commission replaced this guideline with the new definition of “illiquid investments” and new regulatory requirements, as summarized above.

Board Responsibilities Under the Liquidity Rule

The Liquidity Rule and the Liquidity Program Release include specific requirements and guidance with respect to a board's oversight of a fund's Liquidity Program. Importantly, the Liquidity Program Release makes clear that the Commission believes "the role of the board under the rule is one of general oversight, and consistent with the obligations [the Commission] expects that directors will exercise their reasonable business judgment in overseeing the program on behalf of the fund's investors."

Designation of Liquidity Program Administrator. The Liquidity Rule requires a fund's board to approve the designation of the fund's investment adviser, officer, or officers (which may not be solely portfolio managers of the fund) responsible for administering the fund's Liquidity Program (the Program Administrator). The Commission noted that permitting a fund's board to designate a Program Administrator "properly tasks the person(s) who are in a position to manage the fund's liquidity risks on a real-time basis with responsibility for administration of the [Liquidity Program]"

Initial Approval of the Liquidity Program. The Liquidity Rule also requires that a fund's board, including a majority of the "independent trustees," initially approve the fund's Liquidity Program.

Review of the Liquidity Program. The Liquidity Rule requires a fund's board to review, no less frequently than annually, a written report from the Program Administrator that addresses the operation of the Liquidity Program and assesses its adequacy and effectiveness of implementation. In a key change from the Proposal, a board will not be required to approve material changes to a Liquidity Program. Instead, such changes should be described in the report from the Program Administrator.

Oversight of the HLIM. In a change from the Proposal, a fund's board will not be required to approve the HLIM or any changes to the HLIM except in circumstances in which the fund seeks to change the HLIM at a time where there is an HLIM Shortfall. The Liquidity Rule also contemplates that, if a fund experiences an HLIM Shortfall for a period of seven consecutive calendar days or less, the Program Administrator would report such HLIM Shortfall to the board at its next regularly scheduled meeting, including an explanation of the cause(s) of the HLIM Shortfall and any actions taken in response. Moreover, to the extent that a fund experiences an HLIM Shortfall for a period of more than seven consecutive calendar days, the Program Administrator must report to the board within one business day with an explanation of how the fund plans to eliminate the HLIM Shortfall within a reasonable period of time.

Reporting Requirements When a Fund Exceeds the 15% Illiquid Investment Limit. The Liquidity Rule requires a fund that holds more than 15% of its net assets in illiquid investments to report such an occurrence to its board within one business day. This report must include an explanation of the extent and causes of the occurrence and a plan to bring the fund's illiquid investments back into compliance with the 15% limit within a

reasonable period of time. In addition, if a fund's illiquid investments exceed the 15% limit for 30 days (and at each consecutive 30-day period thereafter), the fund's board, including a majority of "independent trustees," must assess whether such plan continues to be in the best interest of the fund.

Section 2: Liquidity Rule Disclosure and Reporting Requirements

The Commission adopted various disclosure and reporting requirements in connection with the Liquidity Rule.

Form N-1A. The Commission adopted amendments to Form N-1A that will require a fund to include more detailed disclosure regarding the methods the fund typically uses to meet redemption requests and its procedures for redeeming the fund's shares, including the number of days following receipt of shareholder redemption requests in which the fund typically expects to pay redemption proceeds to redeeming shareholders.

New Form N-LIQUID. The Commission adopted Rule 30b1-10 under the 1940 Act, which requires a fund to file a current report to the Commission on new Form N-LIQUID (on a non-public basis) when certain significant events related to a fund's liquidity occur. Specifically, a fund is required to file Form N-LIQUID within one business day of the occurrence of one or more of the following events:

- if more than 15% of the fund's net assets are, or become, illiquid investments as defined in the Liquidity Rule;
- if the fund's illiquid investments previously exceeded 15% of net assets, but the fund has since determined that its holdings in illiquid investments have changed to be less than or equal to 15% of its net assets; or
- if the fund's HLIM Shortfall persists for more than seven consecutive calendar days.

Form N-PORT. A fund will be required to report on Form N-PORT (on a non-public basis) the following information with respect to its liquidity:

- the liquidity classification for each of the fund's positions; and
- the fund's HLIM, if applicable, and the number of days on which the fund experienced an HLIM Shortfall during the reporting period, as well as whether the fund's HLIM changed during the period.

Form N-PORT will also include public reporting of aggregate percentages of a fund's portfolio investments in each liquidity category.

Form N-CEN. A fund will be required to publicly report on Form N-CEN information regarding the fund's use of lines of credit, interfund lending and interfund borrowing.

Section 3: Compliance Dates

The compliance date for funds to adopt and implement a Liquidity Program will be December 1, 2018, for

fund complexes with \$1 billion or more in net assets as of the end of the most recent fiscal year, and June 1, 2019, for fund complexes with less than \$1 billion in net assets as of the end of the most recent fiscal year. These compliance dates also apply with respect to filing reports on new Forms N-PORT and N-CEN.

The compliance date for the amendments to Form N-1A will take effect on June 1, 2017, regardless of the size of the overall fund complex.

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