October 27, 2016

SEC Finalizes Rules Requiring Liquidity Risk Management by Open-End Funds

In an October 13, 2016 release (the "Release"), the SEC adopted Rule 22e-4 (the "Rule") and published new disclosure and data reporting requirements.[1] Most notably:

- ***The Rule requires open-end funds (including exchange-traded funds but not money market funds) to adopt a liquidity risk management program.*** Under its program, a fund must assess and manage its liquidity risk, including classifying investments into specific liquidity categories, and maintaining a portion of its holdings in cash and assets that can be converted to cash within three business days.

- ***The new public disclosure and SEC data reporting requirements cover information about a fund's liquidity risk and how that liquidity risk is managed.*** These requirements are implemented through amendments to Form N-1A and through additional reporting requirements on Forms N-PORT and N-CEN and N-LIQUID.

The Release describes these changes as "reforms . . . designed to provide investors with increased protection regarding how liquidity in their open-end funds is managed, thereby reducing the risk that funds will be unable to meet redemption or other legal obligations, and mitigating dilution of the interests of fund shareholders." The Release marks the advance of two components of the SEC's regulatory agenda announced by Chair White in late 2014—enhancing controls on risks related to portfolio management and enhancing data reporting.

These requirements are described in detail below. The principal differences between the liquidity risk management program as required by the Rule and as proposed by the Proposing Release are summarized in a table at the end of this Alert.

Liquidity Risk Management Programs

The Rule requires an open-end fund,[2] to establish a written liquidity risk management program reasonably designed to assess and manage the fund's 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."[3] A fund's liquidity risk management program ("Program") must include written policies and procedures

[1] The Rule was proposed in a September 22, 2015 release (the "Proposing Release"), which also proposed amending Rule 22c-1 (the forward-pricing rule) to permit adjustments to the NAV of an open-end fund ("swing pricing"). The SEC published its final swing pricing rule in a separate release on October 13, 2016 (available here), which will be the subject of a forthcoming Ropes & Gray Alert.

[2] Unless otherwise noted, "open-end funds" and "funds" include exchange-traded funds ("ETFs"). While not included in the scope of the Rule, the Release provides guidance to unit investment trusts (UITs) on liquidity risk management. Specifically, it notes that, at inception, the depositor must determine that the portion of illiquid investments that a UIT holds or will hold at the date of deposit is consistent with the redeemable nature of UIT securities.

[3] The final definition drops the Proposing Release's "without materially affecting the fund's net asset value" requirement in favor of the "without significant dilution" requirement. Notwithstanding this change, the SEC stated in the Release that "we believe impacts on valuation may play a significant role in evaluating the ability to effectively meet shareholder redemptions."

reasonably designed to incorporate the following elements:

- Classifying the liquidity of each of the fund's investments;
- Assessing and periodically reviewing the fund's liquidity risk;
- Managing the fund's liquidity risk by determining the fund's "highly liquid investment minimum" and responding to shortfalls if the fund's level of highly liquid investments fall below that minimum;
- Managing the fund's liquidity risk by limiting the fund's investments in illiquid "investments that are assets" to no more than 15% of the fund's net assets;[4]
- Adopting policies and procedures for in-kind redemptions, if the fund engages in, or reserves the right to engage in, redemptions in kind; and
- Board oversight of the Program.

These elements are discussed below.

Classification of the Liquidity of Each Investment. An open-end fund (other than an "In-Kind ETF")[5] must classify each of its investments into one of four liquidity categories.

Highly Liquid Investment	Moderately Liquid Investment	Less Liquid Investment	Illiquid Investment[6]
Cash and any investment the fund reasonably expects to be convertible to cash in current market conditions **in 3 business days or less** without the conversion to cash significantly changing market value	Any investment the fund reasonably expects to be convertible to cash in current market conditions in **more than 3 calendar days but no more than 7 calendar days** without the conversion to cash significantly changing the market value	Any investment the fund reasonably expects can be sold or disposed of in current market conditions in **7 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 7 calendar days**	Any investment the fund reasonably expects cannot be sold or disposed of in current market conditions in **7 calendar days or less** without the sale or disposition significantly changing the market value of the investment

The fund must review its investments' classifications, at least monthly and more frequently if changes are reasonably expected to materially affect one or more of its investments' classifications.[7] The fund may classify and review its

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The Release further stated that the SEC believes that the inclusion of a "conceptual relationship between liquidity and sale price in the definition of 'liquidity risk' is appropriate."

[4] The Rule refers to "investments" to capture liabilities (*e.g.*, certain out-of-the-money derivatives transactions), as well as assets. This leads to the term "investments that are assets."

[5] "In-Kind ETF" means 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.

[6] The adopted definition of "illiquid" is based on the number of days in which the fund reasonably expects the investment would be sold or disposed of "in current market conditions without significantly changing the market value of the investment." This is consistent with the terminology used for the other three categories, but it departs somewhat from the SEC's longstanding guidance that a fund asset is should be considered illiquid if it cannot be sold or disposed of in the ordinary course of business within seven days at approximately the value ascribed to it by the fund.

investments, including certain derivatives, according to their asset class instead of classifying and reviewing each investment individually. In classifying and reviewing its investments or asset classes:

- A fund must determine whether trading varying portions of its position in an investment or asset class (in sizes that the fund would reasonably anticipate trading) is reasonably expected to significantly affect its liquidity. If so, the fund must take this determination into account when classifying the liquidity of that investment or asset class.

- For derivatives transactions that the fund has classified as moderately liquid investments, less liquid investments, and illiquid investments, a fund must identify the percentage of the fund's highly liquid investments that it has segregated to cover (or pledged to satisfy margin requirements in connection with) derivatives transactions in each of these classification categories (collectively, "Segregated Assets," which are discussed below).[8]

- A fund must take into account "market, trading and investment-specific considerations" when classifying its investments.[9]

Liquidity Risk Assessment and Review. An open-end fund 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 non-exhaustive list of factors, as applicable:

- The fund's investment strategy and the liquidity of its 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;[10]

- Short-term and long-term cash flow projections during both normal and reasonably foreseeable stressed conditions; and

- Holdings of cash and cash equivalents, as well as borrowing arrangements and other funding sources.

For an ETF, including an "In-Kind ETF," the factors also must include:

- 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

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[7] A fund must classify "using information obtained after reasonable inquiry" and, according to the Release, should not predict how an "investment may trade in stressed market conditions [that] would introduce an additional layer of subjectivity into the classification process." However, there may be tension between this limitation and the Rule's requirement that a fund "must review its portfolio investments' classifications, at least monthly . . . and more frequently if changes in relevant market, trading, and investment-specific considerations are reasonably expected to materially affect one or more of its investments' classifications."

[8] The Rule steps back from the Proposing Release regarding the classification of Segregated Assets. The Proposing Release would have required a fund to classify Segregated Assets based upon the liquidity of the derivative instruments they are covering.

[9] This is a change from the Proposing Release, which had an enumerated list of factors for a fund to consider. Instead, the Rule includes these general factors and refers to the proposed factors as "guidance."

[10] The Release notes that the phrasing of "borrowings for investment purposes and derivatives" was consciously selected in order to make clear that the periodic review "should consider all derivatives, including those used for hedging purposes."

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

Liquidity Risk Management—Highly Liquid Investment Minimum. An open-end fund is required to determine the minimum amount of fund net assets that the fund invests in highly liquid investments that are assets. The Rule, while requiring that the minimum must be based on the consideration of the Liquidity Risk Assessment factors above, does not provide a formula to calculate the highly liquid investment minimum.[11] In a change from the Proposing Release, a fund's board of directors/trustees ("Board") is not required to approve a fund's highly liquid investment minimum. However, a highly liquid investment minimum cannot be changed during any period that the level of the fund's highly liquid investments is below the determined minimum without approval from the fund's Board, including a majority of its members who are not interested persons of the fund.

- In another change from the Proposing Release, funds that primarily holds assets that are highly liquid investments, as well as In-Kind ETFs, are not required to determine a highly liquid investment minimum. The Rule does not define what constitutes "primarily," but the Release states that "if a fund held less than 50% of its assets in highly liquid investments it would be unlikely to qualify as 'primarily' holding assets that are highly liquid investments." The Release also states that the SEC would expect a fund that primarily holds highly liquid assets to address in its Program how it makes that determination, including how it defines "primarily."

- The Rule also provides that, for purposes of determining whether a fund primarily holds assets that are highly liquid investments, the fund must exclude from its calculations the percentage of its assets that are Segregated Assets.

A fund must review at least annually its highly liquid investment minimum and adopt and implement policies and procedures for responding to a shortfall of the fund's highly liquid investments below that minimum. The person(s) designated to administer the Program (the "Administrator") must report to the fund's Board, no later than its next regularly scheduled meeting, a brief explanation of the causes of any shortfall, the extent of the shortfall, and any actions taken in response. If the shortfall lasts more than 7 consecutive calendar days, the Administrator must report to the fund's Board within one business day an explanation of how the fund plans to restore its minimum within a reasonable period of time. As described below, a Form N-LIQUID must be filed with the SEC within one business day after a 7-day shortfall has occurred.

Liquidity Risk Management—Limitation on Illiquid Investments. The Rule implements a 15% limit on illiquid investments, as defined in the Rule (which differs from the SEC's longstanding guidance).[12] The Rule also contains related reporting requirements. Specifically, the Rule prohibits a fund from acquiring any illiquid investment if, immediately after the acquisition, the fund's investment in illiquid "investments that are assets" is more than 15% of the fund's net assets. If a fund exceeds the 15% limit, the Administrator is required to notify the fund's Board within one business day with an explanation of the extent and causes of the event, and a plan for how the fund will be brought back into compliance with the 15% limit within a reasonable period. If the 15% limit remains exceeded for 30 days, the fund's Board, including a majority of its members who are not interested persons of the fund, must assess whether the plan presented to it by the Administrator continues to be in the best interest of the fund.

[11] The SEC stated in the Release that "an important feature of the highly liquid investment minimum requirement … is the flexibility it provides for a fund to determine an appropriate highly liquid investment minimum considering its particular risk factors." Nevertheless, the SEC emphasized the role of the minimum: "together with the rest of the liquidity risk management program requirements . . . [the highly liquid investment minimum] is a central tool to help put a fund in a solid position to meet redemption requests without significant dilution of remaining investors' interests."
[12] *See* note 6.

In-Kind Redemptions. The Rule requires an open-end fund that engages in, or reserves the right to engage in, redemptions in kind to establish policies and procedures regarding how and when it will engage in redemptions in kind.

Board Oversight. A fund's Board, including a majority of its members who are not interested persons of the fund, must (i) initially approve the Program, (ii) approve the designation of the Administrator, which can be the fund's investment adviser or one or more fund officers, but may not be solely portfolio managers of the fund and (iii) review, no less frequently than annually, a written report prepared by the Administrator that addresses the operation of the Program and assesses its adequacy and effectiveness of implementation, including the operation of the highly liquid investment minimum (if applicable) and any material changes to the Program. Notably, the Release eliminates the Proposing Release's requirements that the Board approve a fund's three-day highly liquid asset minimum (now, the highly liquid investment minimum) and any material changes to the Program.[13]

New Disclosure and Data Reporting Requirements

The Release creates a number of disclosure and reporting obligations intended to increase the amount and quality of information available to the SEC and investors regarding a fund's redemption practices, its management of liquidity risks and how liquidity risk management can affect redemptions.

New Form N-LIQUID. The Release adopts new Rule 30b1-10, which requires an open-end fund that experiences any of the liquidity events specified on Form N-LIQUID to file with the SEC a report on that Form within one business day of the occurrence the event. The following events trigger a Form N-LIQUID filing requirement:

- A fund exceeds the 15% limit.
- A fund that has exceeded the 15% limit and already filed a Form N-LIQUID no longer exceeds the 15% limit.
- A fund is below its highly liquid investment minimum for more than 7 consecutive calendar days.

The SEC will not make public the information reported on Form N-LIQUID in a form identifiable to any particular registrant.

Form N-1A. The Release adopts, substantially as set forth in the Proposing Release, amendments to Form N-1A. Differences from the Proposing Release are <u>underlined</u> in the following text. As amended, Form N-1A will require a fund to disclose (i) the number of days within which the fund <u>typically expects to</u> pay redemption proceeds to shareholders (if the number of days in which the fund will pay redemption proceeds differs by <u>method of payment</u> (instead of the proposed "distribution channel"), the fund also must disclose the range of days); and (ii) the methods that the fund <u>typically</u> uses to satisfy redemption requests (*e.g.*, cash equivalents maintained by the fund, proceeds of the sale of portfolio holdings, or borrowings by the fund) and whether those disclosed methods are used regularly or only in stressed market conditions.

The Release discards the Proposing Release's requirement that a fund must file with the SEC any credit agreements to which the fund is a party as exhibits to the fund's registration statement.

[13] Commenters rejected these requirements on the grounds that they diverged from the Board's traditional role, representing the interests of fund shareholders through independent oversight, and brought the Board into a management role. The SEC agreed with these commenters.

Form N-PORT.[14] New Form N-PORT requires each fund to report (i) the liquidity classification assigned to each portfolio investment (which may be based on asset type, as described above), (ii) the asset type label that the fund has assigned to each portfolio investment (using any asset type labeling the fund employs in its own portfolio management systems) and (iii) the fund's highly liquid investment minimum. This information is required to be filed monthly but will not be made public.

The Release also requires a fund to report the aggregate percentage of investments that are assets (excluding any investments that are reflected as liabilities) compared to total investments that are assets in each of the following categories: highly liquid investments, moderately liquid investments, less liquid investments and illiquid investments. This information, while reported monthly, will be made public every third month of each fiscal quarter with a 60-day lag.

With respect to derivatives transactions, the Release requires disclosure of the percentage of the Fund's highly liquid investments that consists of Segregated Assets that it has segregated to cover, or pledged to satisfy margin requirements, in connection with derivatives transactions that are classified as moderately liquid investments and less liquid investments. This information, while reported monthly, will be made public every third month of each fiscal quarter with a 60-day lag.

Form N-CEN. New Form N-CEN requires a fund to disclose certain information about its use of lines of credit, inter-fund lending and inter-fund borrowing.

Guidance Regarding Cross-Trades

Like the Proposing Release, the Release reminds investment advisers of Rule 17a-7's requirement to effect cross trades at the "current market price." Responding to questions it received during the comment process, the SEC noted that Rule 17a-7 trades involving "less liquid assets" may require careful review and "potentially even a heightened review" before a fund engages in them.

The Release states that a fund's Rule 38a-1 compliance policies and procedures related to Rule 17a-7 generally should contemplate how the fund meets Rule 17a-7's requirements with respect to less liquid assets.

Compliance Dates

The compliance date for adopting and implementing a Program depends on the size of the fund complex. For funds in the same "group of related investment companies" with net assets of $1 billion or more, the compliance date is December 1, 2018. The compliance date for funds within a smaller group is June 1, 2019.

The compliance date for the additional liquidity-related reporting requirements within Form N-PORT and Form N-CEN also depends on the size of the fund complex. For funds in the same group of related investment companies with net assets of $1 billion or more, the compliance date is December 1, 2018. The compliance date for funds within a smaller group is June 1, 2019.

The compliance date for the amendments to Form N-1A is June 1, 2017, regardless of the size of the group of related investment companies.

If you would like to learn more about the issues in this Alert, please contact your usual Ropes & Gray attorney.

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[14] The SEC published its final Form N-PORT and Form N-CEN in a separate release on October 13, 2016 (available here), which will be the subject of a forthcoming Ropes & Gray Alert.

Comparison of Key Features of Proposed and Final Rule 22e-4

Topic	Proposed	Final
Definition of Liquidity Risk	The 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 net asset value	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
Classification of Fund Investments	6 categories based on days required to convert asset to cash	4 categories, based on days required to convert to cash and/or settle Definition of "illiquid" differs from SEC's longstanding guidance
	Classify each asset individually	Classify individually or according to asset class
	No discussion of liabilities	Rule refers to "investments" to capture liabilities (*e.g.*, certain out-of-the-money derivatives transactions), as well as assets
	Liquid assets serving as cover or margin for a derivatives transaction classified in the same category as the derivative instrument	The percentage of highly liquid investments that consists of Segregated Assets must be identified
	Review classifications on an ongoing basis	Review classifications at least monthly
Liquidity Risk Assessment and Review	Review periodically, including consideration of a non-exhaustive list of factors	Review at least annually, including consideration of a non-exhaustive list of factors
	No special requirements for an ETF	For an ETF, including an "In-Kind ETF," 2 additional factors must be included in review

Topic	Proposed	Final
Liquidity Risk Management—based on an established minimum	Determine and review at least semi-annually the fund's "3-day liquid asset minimum"	Determine and review annually the fund's highly liquid investment minimum required for each fund. This requirement does not apply to an In-Kind ETF or a fund that "primarily holds assets that are highly liquid investments" For purposes of determining whether a fund primarily holds assets that are highly liquid investments, the fund must exclude from its calculations the percentage of highly liquid investments that consists of Segregated Assets
	Fund prohibited from acquiring any asset, other than a 3-day liquid asset if, after the acquisition, the fund would hold fewer 3-day liquid assets than the percentage specified under its 3-day liquid asset minimum	Fund that falls below its highly liquid investment minimum is not prohibited from acquiring a security that is not a highly liquid investment
		If the fund falls short of its highly liquid investment minimum, the Administrator must report to the Board, no later than its next regularly scheduled meeting, a brief explanation of the causes of any shortfall, the extent of the shortfall, and any actions taken in response If the shortfall lasts more than 7 consecutive calendar days, the Administrator must report to the Board within one business day an explanation of how the fund plans to restore its minimum within a reasonable period of time Fund must file a report on Form N-LIQUID within 1 business day of a 7-day shortfall

Topic	Proposed	Final
Liquidity Risk Management—Limitation on Illiquid Investments	Fund prohibited from acquiring any "illiquid" asset (SEC's long-established definition) if, immediately after the acquisition, more than 15% of the fund's net assets are illiquid assets	Fund prohibited from acquiring any "illiquid investment" if, immediately after the acquisition, the fund's investment in illiquid "investments that are assets" is more than 15% of the fund's net assets. Definition of "illiquid" differs from SEC's long-established definition If a fund exceeds the 15% limit, the Administrator is required to notify the fund Board within one business day with an explanation of the extent and causes of the event, and a plan for how the fund will be brought back into compliance with the 15% limit within a reasonable period If the 15% limit remains exceeded for 30 days, the Board must assess whether the plan presented to it by the Administrator continues to be in the best interest of the fund Fund must file a report on Form N-LIQUID within 1 business day if the fund exceeds the 15% limit. Thereafter, a fund must file a report on Form N-LIQUID within 1 business day when the fund no longer exceeds the 15% limit
Board's Role	Board must approve a fund's 3-day highly liquid asset minimum and any material changes to the Program	These requirements eliminated