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What You Need to Know About the SEC's New Liquidity Risk Management Rule

SEC Adopts New Rule 22e-4 to Require Funds to Adopt Liquidity Risk Management Programs

by John M. Baker and Joel D. Corriero

On October 13, 2016, the U.S. Securities and Exchange Commission (SEC) adopted new Rule 22e-4 under the Investment Company Act of 1940 (1940 Act) to require registered open-end funds, other than money market funds, to adopt and implement written liquidity risk management programs.[1] The SEC also adopted related reporting and disclosure requirements. The action was taken in conjunction with rule and form amendments intended to modernize the reporting and disclosure of information by registered investment companies,[2] and rule amendments to permit open-end funds to use swing pricing to effectively pass on the costs stemming from shareholder purchase or redemption activity to the shareholders associated with that activity.[3]

This *Fund Alert* describes the key provisions of Rule 22e-4 and related requirements and identifies significant changes from the rule as originally proposed.[4]

I. Overview

A. Rationale for the Liquidity Risk Management Reforms

Under the 1940 Act, registered open-end funds, including exchange-traded funds (ETFs), are required to redeem their securities upon demand within

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[1] Investment Company Liquidity Risk Management Programs, Release Nos. 33-10233, IC-32315 (Oct. 13, 2016) (Adopting Release), https://www.sec.gov/rules/final/2016/33-10233.pdf.

[2] Investment Company Reporting Modernization, Release Nos. 33-10231, 34-79095, IC-32314 (Oct. 13, 2016) (Fund Reporting Modernization Release), https://www.sec.gov/rules/final/2016/33-10231.pdf. *See Fund Alert,* Investment Company Reporting Modernization Amendments - A Summary of an Extensive Overhaul (Nov, 7, 2016), http://www.stradley.com/insights/publications/2016/11/fund-alert-november-7-2016.

[3] Investment Company Swing Pricing, Release Nos. 33-10234, IC-32316 (Oct. 13, 2016), https://www.sec.gov/rules/final/2016/33-10234.pdf. *See Fund Alert,* What You Need to Know About the SEC's New Swing Pricing Rule (Oct. 24, 2016), http://www.stradley.com/insights/publications/2016/10/fund-alert-october-24-2016. Swing pricing was originally part of the SEC's liquidity proposal, but was adopted as a separate rulemaking.

[4] Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release, Release Nos. 33–9922, IC–31835 (Sept. 22, 2015), 80 Fed. Reg. 62274 (Oct. 15, 2015) (Proposing Release), https://www.federalregister.gov/d/2015-24507.

seven calendar days.[5] Where the fund share redemption orders are placed through a broker-dealer, Rule 15c6-1 under the Securities Exchange Act of 1934 (1934 Act) currently requires such redemptions to be settled within three business days, and the SEC has recently proposed to reduce the settlement time to two business days.[6] In practice, many funds state in their prospectuses that investors ordinarily will receive redemption proceeds more quickly.

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Evolution of the open-end fund industry in recent decades has focused the attention of the SEC and other regulators on the role of open-end fund liquidity and liquidity management practices in the financial markets.[7] In proposing Rule 22e-4, the SEC noted a number of factors – significant growth in the assets of open-end funds, more complex markets, and more complex investment strategies pursued by open-end funds, including fixed income and alternative investment strategies focused on less liquid asset classes – that, in the SEC's view, have increased the importance of liquidity risk management. Moreover, after the rule was proposed and during the comment period, there was a widely publicized instance of an open-end fund failing to maintain sufficient liquidity to meet redemption requests, a development that the SEC cited as an example demonstrating "the significant adverse consequences to remaining investors in a fund when it fails to adequately manage liquidity."[8]

New Rule 22e-4 and the related actions (Liquidity Reforms) are designed to promote effective liquidity risk management throughout the open-end fund industry by reducing the risk that funds will be unable to meet shareholder redemption requests or other legal obligations, and mitigating dilution of the interests of fund shareholders. These reforms also are intended to give investors better information to make investment decisions, and to give the SEC better information to conduct comprehensive monitoring and oversight of the fund industry.[9]

Rule 22e-4 will require all open-end funds other than money market funds (funds) to adopt and implement a written liquidity risk management program (Liquidity Risk Management Program, or Program) that is reasonably designed to assess and manage its liquidity risk. Exchange-traded funds that are open-end funds (ETFs) are

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[5] 1940 Act § 22(e).

[6] Amendment to Securities Transaction Settlement Cycle, No. 34-78962 (Sept. 28, 2016), 81 Fed. Reg. 69240 (Oct. 5, 2016) (T+2 Proposing Release), https://www.federalregister.gov/d/2016-23890.

[7] *See* Financial Stability Oversight Council, Notice Seeking Comment on Asset Management Products and Activities, Docket No. FSOC-2014-0001 (Dec. 18, 2014), 79 Fed. Reg. 77488 (Dec. 24, 2014) (requesting information about, among other things, open-end fund liquidity and ability to meet redemptions), https://www.federalregister.gov/d/2014-30255.

[8] Adopting Release, *supra* note 1, at 7. "For example, during the pendency of our proposal, the Third Avenue Focused Credit Fund, a non-diversified open-end fund, adopted a plan of liquidation, and requested and obtained exemptive relief to suspend shareholder redemptions. The Commission noted that the fund represented that, at the time the fund and its investment adviser requested exemptive relief, it had experienced a significant level of redemption requests over the prior six-month period that reduced the fund's portfolio liquidity, as well as a significant decline in its NAV. The fund's board authorized the plan of liquidation after it determined that additional redemptions would have to be made at prices that would unfairly disadvantage the fund's remaining shareholders. This event highlights the extent to which shareholders can be harmed when a fund holding portfolio assets that entail significant liquidity risk does not adequately anticipate the effects of market deterioration and increased shareholder redemptions." Adopting Release, *supra* note 1, at 31 – 32 (footnotes omitted).

[9] *Id.* at 11.

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subject to the general Program requirement, but ETFs that meet redemptions through in-kind transfers of securities, positions, and assets (other than a de minimis amount of cash) and that publish their portfolios daily (In-Kind ETFs) are not subject to some of the specific requirements.

B. Key Provisions of the Liquidity Reforms

1. Rule 22e-4. Liquidity Risk Management Programs

(a) Program. Each fund must adopt and implement a written Liquidity Risk Management Program that is reasonably designed to assess and manage its liquidity risk.

(b) Definition of Liquidity Risk. Liquidity risk is defined as the risk that the fund could not meet requests to redeem shares issued by the fund without significant dilution of remaining investors' interests in the fund.

(c) Required Program Elements. Each Program must include the following required elements:

(i) Assessment, Management, and Periodic Review of Liquidity Risk.

Each fund must assess, manage, and periodically review (at least annually) its liquidity risk, based on the following factors stated in the rule (the Liquidity Risk Factors), as applicable.[10]

Liquidity Risk Factors:

- 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.
- Short-term and long-term cash flow projections during both normal and reasonably foreseeable stressed conditions.
- Holdings of cash and cash equivalents, borrowing arrangements, and other resources.
- For ETFs:
  - The relationship between the ETF's portfolio liquidity and its trading characteristics; and
  - The effect of the composition of baskets on the overall liquidity of the ETF's portfolio.

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[10] Rule 22e-4(b)(1)(i).

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(ii) Classification of Portfolio Holdings

Each fund, other than In-Kind ETFs, must classify each of the fund's portfolio investments (including derivatives) into one of the following four categories, based on the number of days reasonably expected to convert the investment to cash (or, in the case of less liquid and illiquid investments, to sell the investment) without the conversion to cash or sale significantly changing its market value, under current market conditions.[11]

Four Liquidity Categories

- *Highly liquid investments:* Cash and investments convertible into cash in three business days or less.[12]
- *Moderately liquid investments:* Investments convertible into cash in more than three calendar days but in seven calendar days or less.[13]
- *Less liquid investments:* Investments that can be sold or disposed of in seven calendar days or less, but where the sale or disposition is reasonably expected to settle in more than seven calendar days.[14]
- *Illiquid investments:* Investments that cannot be sold or disposed of in seven calendar days or less.[15]

Classification Factors

The classification determinations must take into account relevant market, trading, and investment-specific considerations, and must be based on information obtained after reasonable inquiry. The classification process must also take into account "market depth" (this requires determining and taking into account whether trading varying portions of a position in a particular investment, in sizes that the fund would reasonably anticipate trading, is reasonably expected to significantly affect the liquidity of that investment). The Adopting Release, but not the Rule itself, sets out nine specific factors, which the fund may use as applicable in classifying asset types and determining whether an exception is appropriate.

Classification by Asset Class, with Exceptions

Classification generally may be determined based on the asset class of the investment, but the fund must separately classify and review any investment if the fund or its adviser has information about any market, trading, or investment-specific considerations that are reasonably expected to significantly affect its liquidity characteristics as compared to other holdings within that asset class.

(iii) Highly Liquid Investment Minimum

Each fund, other than In-Kind ETFs and funds primarily holding highly liquid assets, must determine and periodically review a highly liquid investment minimum (the percentage of the fund's assets held in highly liquid investments). A fund must adopt and implement policies and procedures for responding to a shortfall

[11] Rule 22e-4(b)(1)(ii).

[12] Rule 22e-4(a)(7).

[13] Rule 22e-4(a)(12).

[14] Rule 22e-4(a)(10).

[15] Rule 22e-4(a)(8).

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of the fund's highly liquid investments below its highly liquid investment minimum, but is not prohibited from acquiring assets that are not highly liquid when a shortfall occurs.[16] The fund may not change the highly liquid investment minimum during any period when the fund is below the minimum without approval from the fund's board, and it must report shortfalls to the fund's board.

(iv) Illiquid Investment Provisions

No fund, including In-Kind ETFs, may acquire any illiquid investment if, immediately after the acquisition, the fund would have invested more than 15% of its net assets in illiquid investments.[17]

In a change from current requirements, funds will be required to review the percentage of the fund's assets held in illiquid assets on an ongoing basis (not only upon acquisition of an illiquid investment). If a fund holds more than 15% of its net assets in illiquid investments, the fund must report to the board within 1 business day of the occurrence of the excess, together with an explanation of the extent of the excess illiquid holdings and a remediation plan for bringing the level of its illiquid investments to 15% or below. If the excess persists for more than 30 days from the occurrence (and each 30 days thereafter if it has not been remedied), the board must assess whether the remediation plan continues to be in the best interest of the fund.

(v) Redemptions in Kind

Funds that engage in (or reserve the right to engage in) redemptions in kind, including In-Kind ETFs, must establish policies and procedures regarding how and when they will engage in redemptions in kind.[18]

(d) Board Oversight

Fund boards must initially approve a fund's Liquidity Risk Management Program and the person(s) designated to administer the Program (Liquidity Program Administrator). The board must also review at least annually a written report assessing the Program's operation, including operation of the highly liquid investment minimum, and any material changes to the Program. Boards are not required to approve the fund's highly liquid investment minimum as a separate component, but must approve a change to a fund's highly liquid asset minimum, if the change occurs while the fund's level of highly liquid assets is below the previously determined minimum. When a fund's illiquid investment assets exceed 15% of the fund's net assets for more than 30 days, the board must determine that the fund's remediation plan for reducing illiquid investments remains in the fund's best interests.

2. Reporting of Liquidity Information - Public Availability

(a) Form N-PORT. Funds must report monthly on new Form N-PORT:

- Holdings level classification for each investment; this is reported to the SEC only, and will not be made public.
- The fund's highly liquid investment minimum and related information; this information is reported to the SEC only, and will not be made public.

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[16] Rule 22e-4(b)(1)(iii).

[17] Rule 22e-4(b)(1)(iv).

[18] Rule 22e-4(b)(1)(v).

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- Portfolio level (aggregate holdings) in each liquidity category; information filed for the third month of the quarter is made public 60 days after the end of the quarter.

- Derivatives - the percentage of highly liquid investments segregated for derivatives in categories other than the highly liquid category; information filed for the third month of the quarter is made public 60 days after the end of the quarter.

(b) Form N-LIQUID. Funds must notify the SEC, on a confidential basis, within 1 business day when the fund's:

- Illiquid investments exceed 15% of net assets.

- Highly liquid investments fall below the fund's minimum for more than 7 days.

3. Compliance Dates

The final rule requires the adoption of a Liquidity Risk Management Program by **December 1, 2018**, for fund complexes with net assets of $1 billion or more and by **June 1, 2019**, for fund complexes with net assets below $1 billion. Earlier and later compliance dates apply to other aspects of the rule, which are described at the end of this Fund Alert.

II. Rule 22e-4 and the Liquidity Risk Management Program Requirement

Each fund's Liquidity Risk Management Program must be reasonably designed to assess and manage its liquidity risk. The Program must include policies and procedures reasonably designed to incorporate the elements specified by Rule 22e-4 and must also include any additional elements a fund deems necessary to effectively assess and manage its liquidity risk.[19]

1. Assessment, Management and Review of Liquidity Risk

The Program adopted by each open-end fund, including In-Kind ETFs, must include a requirement that the fund assess, manage, and periodically review its liquidity risk, with such review occurring no less frequently than annually.[20] This does not require that a fund eliminate all adverse impacts of liquidity risk, which would be incompatible with an investment product such as an open-end fund.[21]

a. Definition of "Liquidity Risk"

"Liquidity risk" is defined as the risk that the fund could not meet requests to redeem shares issued by the fund without significant dilution of remaining investors' interests in the fund.[22] Thus, liquidity risk involves the risk that a fund will not be able to meet redemption requests under any circumstances, as well as the risk that a fund could meet redemption requests, but only in a manner that adversely affects the fund's

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[19] Adopting Release, *supra* note 1, at 61.

[20] Rule 22e-4(b)(1)(i).

[21] Adopting Release, *supra* note 1, at 61.

[22] Rule 22e-4(a)(11).

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non-redeeming shareholders through significant dilution.[23] The reference to "significant" dilution is intended to convey that the definition is not meant to reference slight movements in the fund's net asset value per share. This definition differs from the definition in the proposed rule, which used the phrase "without materially affecting the fund's net asset value."

b. Liquidity Risk Factors

A fund's assessment, management and review of liquidity risk must include consideration of its investment strategy and portfolio liquidity, cash flow projections, and holdings of cash and cash equivalents. To the extent a factor is not applicable to a particular fund, the fund will not be required to consider it, but a fund must take into account any other considerations to the extent necessary to adequately assess and manage its liquidity risk.[24]

1. Investment Strategy and Portfolio Liquidity

In assessing liquidity risk, a fund must consider its investment strategy and the liquidity of its portfolio investments during both normal and reasonably foreseeable stressed conditions, including 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.[25] This factor requires a fund to consider whether it has a liquidity risk management framework in place that corresponds with the liquidity risks inherent in its strategy and with its structure as a fund that offers redeemable securities.[26]

In a change from the proposed rule, this factor expressly requires a fund to consider whether its investment strategy is appropriate for an open-end fund. The SEC indicated that factors which would bear on this consideration would include the suitability of strategies that are highly concentrated or where it may be difficult to find buyers of portfolio securities during stressed conditions, whether the fund holds primarily securities with extended settlement periods beyond seven days, and whether the fund holds illiquid investments in excess of 15% of net assets where it appears unlikely that the fund will be able to reduce its illiquid investment holdings to or below 15% within a period of time commensurate with its redemption obligations. This is intended to be an on-going analysis, where a fund's periodic liquidity risk review could lead to reconsideration of whether operation as an open-end fund remains appropriate.[27]

This factor also requires an evaluation of whether the fund's investment strategy involves a relatively concentrated portfolio or large positions in particular issuers, and a fund must consider its use of borrowings for investment purposes and derivatives, including derivatives for hedging purposes, within the requirement to consider investment strategy. In applying the requirement to consider normal and reasonably foreseeable stressed conditions, funds should consider historical experience but should recognize that such experience may not necessarily be indicative of future outcomes, depending on changes in market conditions and the fund's particular circumstances.[28]

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[23] Adopting Release, *supra* note 1, at 59.

[24] *Id.* at 65 – 66.

[25] Rule 22e-4(b)(1)(i)(A).

[26] Adopting Release, *supra* note 1, at 69.

[27] *Id.* at 69 – 70.

[28] *Id.* at 75.

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2. Cash Flow Projections

A fund must consider short-term and long-term cash flow projections during both normal and reasonably foreseeable stressed conditions.[29] A fund should generally review the size, frequency, and volatility of historical purchases and redemptions of fund shares across a variety of market conditions in order to determine how the fund's flows may differ during normal and reasonably foreseeable stressed periods. In addition to considering its own historical flow data, a fund, particularly a fund without substantial operating history, should consider purchase and redemption activity in funds with similar investment strategies.[30] Other considerations that will impact cash flow projections include 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.[31]

3. Holdings of Cash and Borrowing Arrangements

A fund must consider its holdings of cash and cash equivalents, as well as borrowing arrangements and other funding sources such as interfund lending.[32] While significant cash and cash equivalent holdings are not necessarily appropriate for all funds, the SEC believes that holdings of cash and cash equivalents can be a valuable liquidity risk management tool because these holdings tend to remain very liquid under nearly all market conditions.[33] Borrowing or other funding arrangements could also assist a fund in meeting redemption requests in certain cases, such as bridging timing mismatches between sale realizations and redemption payment obligations.[34]

c. Periodic Review of a Fund's Liquidity Risk

A fund must periodically review its liquidity risk, taking into account the same Liquidity Risk Factors.[35] The periodic review must be conducted at least annually, but a fund may determine that it is appropriate for its liquidity risk to be reviewed more frequently than annually.[36]

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[29] Rule 22e-4(b)(1)(i)(B).

[30] Adopting Release, *supra* note 1, at 80.

[31] *Id.* at 78 – 83.

[32] Rule 22e-4(b)(1)(i)(C).

[33] Adopting Release, *supra* note 1, at 83 – 84.

[34] *Id.* at 85. Some funds may consider engaging in cross-trades between affiliated funds to be a useful liquidity management tool. The Adopting Release indicates that compliance policies and procedures related to Rule 17a-7, which governs cross-trades, generally should contemplate how the fund meets Rule 22e-4's requirements with regard to less liquid assets, and specifically address how the fund would determine that such less liquid securities are appropriately used when meeting the requirements of Rule 17a-7. *See id.* at 247.

[35] *Id.* at 87.

[36] *Id.* at 89.

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2. Classification of Portfolio Investments

Each open-end fund, other than In-Kind ETFs, must classify each portfolio investment into one of four liquidity categories, based on the number of days within which it reasonably expects the investment would be converted into cash (or, for less liquid and illiquid investments, sold or disposed of) without the sale, disposition, or conversion significantly changing the market value of the investment. The requirement applies to every portfolio investment, including derivatives transactions that are liabilities.[37]

a. Classification Requirement

An open-end fund (other than an In-Kind ETF) must classify each portfolio investment as a highly liquid, moderately liquid, less liquid, or illiquid investment. The classifications must take into account relevant market, trading, and investment-specific considerations obtained after reasonable inquiry. The classifications must be reviewed 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 investments' classifications.[38] The adoption of four classification categories was one of the most dramatic changes from the proposed rule, which had included six "convertible to cash" categories as well as provisions relating to a separate category of illiquid securities.

Although the original proposal included nine liquidity classification factors for funds to consider, the rule as adopted is a principles-based requirement that a fund take into account relevant market, trading, and investment-specific considerations. The nine factors that were in the proposed rule are now set forth in the Adopting Release as guidance, together with an extensive discussion of how each factor might be applied in classifying fund investments in different asset classes and making exception determinations under a range of circumstances.[39] A fund may use liquidity data and analyses provided by third-party service providers to inform or supplement its own consideration of the liquidity of an asset class or investment, but is not required to do so.[40]

The assessment of each investment's liquidity is based on the fund's reasonable expectations in current market conditions. This is in contrast to the requirement to assess, manage and review liquidity risk, which must also consider reasonably foreseeable stressed conditions. The SEC does not expect funds to estimate to a precise degree the market impact of trading an investment.[41]

The standard captures only value impacts that "significantly change" the investment's market value, rather than the proposed standard that focused on "materially affecting" the value of the asset immediately prior to sale. The SEC believes that a fund's classification policies and procedures should address what it would consider to be a significant change in market value.[42] While the new rule does not precisely define which changes are considered "significant," the SEC suggests the standard is more than "material" but short of "fire sale discounting."[43]

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[37] *Id.* at 89 – 90 and n.276.

[38] Rule 2e-4(b)(1)(ii).

[39] Adopting Release, *supra* note 1, at 154 – 74.

[40] *Id.* at 103.

[41] *Id.* at 107.

[42] *Id.* at 108.

[43] *See id.* at 107 – 08.

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b. Liquidity Categories

1. Highly Liquid Investments

"Highly liquid investment" means any cash held by a fund and any investment that the fund reasonably expects to be convertible into cash in current market conditions in three business days or less without the conversion to cash significantly changing the market value of the investment.[44] "Convertible into cash" refers to the ability to sell the investment, with the sale settled.[45] Highly liquid investments do not necessarily include all assets that trade on a T+3 basis (i.e., with settlement on the third business day after the trade date), because the required three business days are the sum of the time required to trade and the time required to settle the trade. The SEC states that it believes it has appropriately defined "highly liquid investments" notwithstanding the proposal in the T+2 Proposing Release to shorten the standard settlement cycle for most broker-dealer transactions from T+3 to T+2.[46]

2. Moderately Liquid Investments

"Moderately liquid investment" means any investment that the fund reasonably expects to be convertible into 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.[47] If an investment could be viewed as either a highly liquid or a moderately liquid investment, the fund should classify the investment as a highly liquid investment.[48]

3. Less Liquid Investments

"Less liquid investment" means any investment that the fund reasonably expects to be able to sell or dispose 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.[49] For example, transactions in bank loan participations and in certain foreign securities may entail longer settlement periods.[50] The Adopting Release notes that if a fund holds a forward contract on a security, such as a forward in a transaction in the "To Be Announced" or "TBA" market, the convert to cash determination for that instrument may be based on the forward contract and not on the underlying securities to be received.[51]

This category is meant to identify investments that may be available to meet redemption requests within seven days, but only to the extent that the fund addresses the lengthier settlement period associated with these investments. A fund generally could use less liquid investments to meet redemptions within seven days only if the fund obtained a line of credit or other source of financing to bridge the period until

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44 Rule 22e-4(a)(6).

45 Adopting Release, *supra* note 1, at 90.

46 *Id.* at 115.

47 Rule 22e-4(a)(12).

48 Rule 22e-4(b)(1)(ii) note.

49 Rule 22e-4(a)(10).

50 Adopting Release, *supra* note 1, at 119 – 20.

51 *Id.* at 120.

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settlement, or if the fund used its cash holdings to meet the redemptions while simultaneously selling the less liquid investment and then replenishing its cash holdings upon settlement.[52] The Liquidity Risk Management Program of a fund that holds less liquid investments must take into account the liquidity risks associated with extended settlement periods.[53]

4. *Illiquid Investments*

"Illiquid investment" means any investment that the fund reasonably expects cannot be sold or disposed of in current market conditions in seven calendar days or less without the sale or disposition significantly changing the market value of the investment.[54] This definition has special significance because of the 15% limit on illiquid investments, discussed below. Although there is an existing 15% limitation on illiquid investments,[55] the SEC is withdrawing existing guidance and replacing it with new regulatory requirements and guidance regarding the process for determining whether a portfolio investment is illiquid.[56]

The SEC states that some fund complexes make liquidity determinations under the current guidelines based on whether a single trading lot for the investment can be sold within seven days under normal market circumstances. Under the new rule, a fund must consider situations in which the size of a fund's holdings could significantly affect those holdings' liquidity, i.e., when portfolio liquidity may be significantly constrained by the fund's ability to trade meaningful portions of its portfolio holdings.[57] Funds should not rely solely on the structural features of an investment to determine that it is not illiquid,[58] and as with other categories, asset classification is subject to monthly or more frequent review. The SEC expects that some funds may determine that a greater percentage of holdings are illiquid under the new rule and guidance.[59]

c. Required Classification Procedures

1. *Classification Based on Asset Class*

A fund may generally classify and review its portfolio investments according to their asset class, although the fund must separately classify and review any investment if the fund or its adviser has information about any market, trading, or investment-specific considerations that are reasonably expected to *significantly* affect the liquidity characteristics of that investment as compared to the fund's other portfolio holdings within that asset class.[60] Each fund can classify assets based on its own experience in the markets, which the SEC indicated would allow fund complexes to leverage existing practices to a greater

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[52] *Id.* at 121.

[53] *Id.* at 131-32.

[54] Rule 22e-4(a)(8).

[55] *See* Revisions of Guidelines to Form N-1A, Release Nos. 33-6927, IC-18612 (Mar. 12, 1992), 57 Fed. Reg. 9828, 9829 (Mar. 20, 1992), https://www.sec.gov/rules/other/1992/33-6927.pdf.

[56] Adopting Release, *supra* note 1, at 126 – 27.

[57] *Id.* at 130.

[58] *Id.* at 126.

[59] *Id.* at 123.

[60] Rule 22e-4(b)(1)(ii)(A).

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degree than under the proposed rule. However, the SEC indicated that very general asset class categories (e.g., "equities," "fixed income," and "other") will not be considered appropriate and more specific asset classes will be expected.[61] Also, the SEC expects that there are some asset classes, such as those encompassing some bespoke complex derivatives or complex structured securities, that have such a range of liquidity characteristics that each position will need to be classified individually.[62]

Importantly, funds will be required to update their asset-class-based classifications as relevant market, trading, and investment-specific considerations warrant, and procedures will need to be developed for this purpose.[63]

2. *Consideration of Market Depth (Position Size)*

In classifying its portfolio investments, a fund must determine and account for 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. This requires funds to assess two variables for each investment or asset class: 1) the position size a fund reasonably anticipates trading and 2) the market depth for that investment. The SEC expects that the position size that a fund would reasonably anticipate trading to be based on multiple factors such as a fund's size, cash flow history, concentration, cash holdings and the degree of stability in the market. If the fund determined, after conducting the required market depth analysis, that a downward adjustment in the liquidity classification of a particular investment is appropriate, the new liquidity classification that the fund assigns to this investment would apply to the entirety of the fund's position in that investment.[64]

This is a significant change from the proposal, which would have required a fund to analyze its ability to trade a full position in an investment and potentially bifurcate the classification of specific investments between two or more liquidity categories. This change was intended to lessen the burdens on funds and advisers of classifying individual investments and also to address commenters' concerns that large funds could be inappropriately identified as less liquid.[65] However, assessing the position size a fund reasonably anticipates trading based on the various fund-specific criteria noted above may still be a significant burden for funds and advisers and may require automated solutions.

d. Assets Linked to Derivatives Transactions

Derivatives held by a fund, such as swaps, options, futures and forwards, are subject to the classification requirement, even derivatives that have a negative value and therefore are not "assets." For derivatives that are classified as moderately liquid, less liquid, or illiquid, a fund will need to identify the percentage of the fund's highly liquid investments that it has segregated as "cover" or pledged to satisfy margin requirements in connection with derivatives transactions, classified in each of the moderately liquid, less liquid, and illiquid classification categories.[66] This disclosure is intended to provide investors an understanding of the percentage of a fund's highly liquid investments that may not be available to satisfy redemptions.

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[61] Adopting Release, *supra* note 1, at 137.

[62] *Id.* at 134.

[63] *Id.* at 137.

[64] *Id.* at 141-43.

[65] *Id.* at 51.

[66] Rule 22e-4(b)(1)(ii)(C). A fund will not need to identify which of its particular assets are used to cover particular derivatives transactions.

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3. Highly Liquid Investment Minimum

Pursuant to Rule 22e-4(b)(1)(iii), funds that do not primarily hold assets that are "highly liquid investments" will be required to determine a "highly liquid investment minimum" considering the Liquidity Risk Factors discussed above. The highly liquid investment minimum is the percentage of a fund's net assets that the fund invests in highly liquid investments.[67] Funds primarily holding highly liquid assets are excluded from the highly liquid investment minimum requirement. Although Rule 22e-4 does not define the term "primarily," the SEC noted that, in its view, funds holding less than 50% of their assets in highly liquid investments would be unlikely to qualify as "primarily" holding assets that are highly liquid investments.[68] The Liquidity Risk Management Program of a fund that claims to primarily hold highly liquid assets should address how the fund determines that it "primarily" holds assets that are highly liquid investments and how it defines "primarily."[69]

In determining whether a fund is meeting its highly liquid investment minimum, the fund should look only to its investments that are assets of the fund (i.e., investments with positive values).[70] Funds are required to exclude from their calculations the percentage of assets that are highly liquid investments that have been segregated to cover derivatives transactions that the fund has classified as moderately liquid investments, less liquid investments, and illiquid investments, or that the fund has pledged to satisfy margin requirements in connection with those derivatives transactions.[71] The highly liquid investment minimum must be reviewed periodically by the fund, but no less frequently than annually.[72] The SEC suggests that funds may wish to adopt procedures specifying any circumstances that would prompt more frequent reviews.[73]

The highly liquid investment minimum requirement is different from the "three-day liquid asset minimum" requirement in the proposed rule in that the three-day liquid asset minimum would have prohibited a fund from acquiring any assets other than three-day liquid assets[74] if it exceeded its three-day liquid asset minimum. In contrast, the highly liquid investment minimum provision of the rule requires only that fund boards adopt policies and procedures for responding to shortfalls of the fund's highly liquid investments below its highly liquid investment minimum.[75] In addition, as proposed, boards would have been required to approve a fund's three-day liquid asset minimum and any subsequent changes thereto, but as adopted, a fund's board generally is not required to approve the fund's highly liquid investment minimum. The only exception is that a board, including a majority of the trustees who are not interested persons of the fund, will be required to approve a change to the fund's highly liquid investment minimum if changes are to be made during any period of time when the fund's highly liquid investments are below the determined minimum.[76]

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[67] Rule 22e-4(a)(7).

[68] Adopting Release, *supra* note 1, at 225 n.726.

[69] *Id.* at 225.

[70] *Id.* at 195 n.633.

[71] Rule 22e-4(b)(1)(iii)(B).

[72] Rule 22e-4(b)(1)(iii)(A)(2). This deviates from the proposed rule, which would have required a periodic review no less frequently than semi-annually.

[73] Adopting Release, *supra* note 1, at 224.

[74] Three-day liquid assets were proposed to be defined as cash and any asset convertible to cash within three business days at a price that does not materially affect the value of the asset immediately prior to sale. Proposing Release, *supra* note 4, 80 Fed. Reg. at 62385.

[75] Rule 22e-4(b)(1)(iii)(A)(3).

[76] Rule 22e-4(b)(1)(iii)(A)(1).

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The SEC believes that the highly liquid investment minimum 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.[77] The SEC also believes that the requirement will help encourage greater consistency in funds' considerations of factors relevant to their liquidity risk management procedures than would be the case if the rule simply required the adoption of policies and procedures to address shareholder redemptions without a minimum requirement.[78]

a. Consideration of Liquidity Risk Factors

Funds will be required to consider the Liquidity Risk Factors when determining their highly liquid investment minimums.[79] Funds are required only to consider the factors that are applicable to the fund.[80] The first two factors should be considered only as they apply during normal conditions, and during stressed conditions only to the extent they are reasonably foreseeable during the period until the next review of the highly liquid investment minimum.[81] This requirement deviates from the proposed rule, and is intended to limit considerations of stressed conditions to whatever time frame the fund has determined for review of its highly liquid investment minimum.[82]

The SEC suggests that the following funds may want to establish higher highly liquid investment minimums: (i) funds with less liquid portfolio investments; (ii) funds with investment strategies that typically have greater volatility of flows, such as alternative funds and emerging market debt funds; and (iii) funds with leveraged strategies.[83] In addition, the SEC suggests that its cash flow guidance considerations could be useful in setting a fund's highly liquid investment minimum. These considerations include: (i) the size, frequency, and volatility of historical purchases and redemptions of fund shares during normal and reasonably foreseeable stressed periods; (ii) the fund's redemption policies; (iii) the fund's shareholder ownership concentration; (iv) the fund's distribution channels; and (v) the degree of certainty associated with the fund's short-term and long-term cash flow projections.[84] Based on these considerations, the SEC suggests that the following funds may also consider establishing higher highly liquid investment minimums: (i) funds with concentrated shareholder bases;[85] and (ii) funds that satisfy all redemptions on a T+1 basis or that are sold through distribution channels that historically attract investors with more volatile and/or unpredictable flows.[86]

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[77] Adopting Release, *supra* note 1, at 199.

[78] *Id.* at 200.

[79] Rule 22e-4(b)(1)(i). See *supra* page 3 for the text of the Liquidity Risk Factors.

[80] Rule 22e-4(b)(1)(iii)(A)(1).

[81] *Id.*

[82] Adopting Release, *supra* note 1, at 205.

[83] *Id.* at 208.

[84] *Id.* at 209 n.681.

[85] The Adopting Release also notes that "[n]ew or recently launched funds that have a concentrated shareholder base should consider disclosing the risk of redemption by one or more such shareholders in the fund's prospectus." *Id.* at 211.

[86] *Id.* at 209-10.

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b. Highly Liquid Investment Minimum Shortfall Policies and Procedures

Funds will be required to adopt and implement policies and procedures for responding to a shortfall of the fund's highly liquid investments below its highly liquid investment minimum (Shortfall Policies and Procedures).[87] The Shortfall Policies and Procedures must require the Liquidity Program Administrator to report to the fund's board no later than its next regularly scheduled meeting a brief explanation of the causes of the shortfall, the extent of the shortfall, and any actions taken in response to the shortfall.[88] Funds that drop below their highly liquid investment minimum multiple times before the next regularly scheduled board meeting could provide a single report to the board at such meeting, discussing each of these occurrences.[89] If the shortfall lasts more than seven consecutive calendar days, the Shortfall Policies and Procedures must require the Liquidity Program Administrator to report to the board within one business day thereafter with an explanation of how the fund plans to restore its minimum within a reasonable period of time.[90] Fund management should generally take into account the fund's level of liquidity risk, as well as the facts and circumstances leading to the shortfall, in determining a reasonable time for returning the fund's assets to the minimum level.[91]

The SEC suggests that a fund's Shortfall Policies and Procedures could include actions a fund could consider taking to respond to shortfalls under various circumstances and conditions. For example, the Shortfall Policies and Procedures could outline circumstances under which it could be appropriate for a fund to purchase assets that are not highly liquid investments, despite being below its minimum. Similarly, a fund could include how it would set out a time frame by which it plans to bring its assets back up to the minimum. Shortfall Policies and Procedures could also, although they are not required to, specify the persons who will typically determine how, if at all, to respond to a shortfall (e.g., the person(s) designated by the board to administer the fund's Liquidity Risk Management Program, in conjunction with the fund's risk managers and portfolio managers).[92]

The SEC suggests that if a fund encounters shortfalls regularly, it should consider whether its risk management policies and procedures should be modified.[93]

4. Limitation on Funds' Illiquid Investments

a. Applicability to Funds (including In-Kind ETFs)

Rule 22e-4(b)(1)(iv) prohibits funds, including In-Kind ETFs, 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 that are assets. Because the limitation applies only to illiquid investments that are "assets," illiquid investments with a negative value are not netted against illiquid investments with positive values or

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[87] Rule 22e-4(b)(1)(iii)(A)(3).

[88] *Id*.

[89] Adopting Release, *supra* note 1, at 221.

[90] Rule 22e-4(b)(1)(iii)(A)(3). As discussed below, there is also a reporting obligation on new Form N-LIQUID.

[91] Adopting Release, *supra* note 1, at 222.

[92] *Id.* at 219-20.

[93] *Id.* at 220.

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otherwise taken into account in applying this limitation.[94] As discussed above, "illiquid investment" means any investment that the fund reasonably expects cannot be sold or disposed of in current market conditions in seven calendar days or less without the sale or disposition significantly changing the market value of the investment, as determined pursuant to the classification provisions of the rule under sub-section (b)(1)(ii).

Although there is no requirement to divest illiquid investments in a fund's portfolio, if a fund holds more than 15% of its net assets in illiquid investments that are assets, it must report such occurrence to the fund's board within one business day of the occurrence.[95] The report must include 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 within a reasonable period of time.[96] 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 (and at each consecutive 30 day period thereafter), the board, including a majority of trustees who are not interested persons of the fund, must assess whether the plan presented to it continues to be in the best interests of the fund.[97]

Note that while the proposed rule incorporated a "codification" of the current 15% guideline on illiquid investments, which has prohibited open-end funds from acquiring additional illiquid investments that would put them over the 15% limit, the final rule includes too many changes from the existing requirements for illiquid investments to be considered a codification (for example, the change in how illiquid investments are defined and the factors used in the determination, the requirement for ongoing review, and the notice provisions in new Form N-LIQUID). In connection with adopting Rule 22e-4, the SEC has withdrawn both its existing guidance on the 15% guideline and the 15% guideline itself.

b. Special Rule for Unit Investment Trusts

Although Rule 22e-4 excludes Unit Investment Trusts (UITs), including UITs that operate as ETFs, from compliance with the rule, their principal underwriters or depositors must determine, on or before the date of initial deposit of portfolio securities into the UIT, that the portion of the illiquid investments that the UIT holds or will hold at the date of deposits that are assets is consistent with the redeemable nature of the securities it issues.[98] The SEC expects that this initial review would be similar to the process for determining whether a fund's holding of illiquid investments is consistent with Rule 22e-4's 15% limitation on illiquid investments, taking into account the unique structure and purpose of UITs.[99] If the UIT tracks an index, the determination should consider the index design and whether the index design is likely to lead to the UIT holding an amount of illiquid assets that is inconsistent with the redeemable nature of the securities it issues.[100]

A record of this determination must be maintained for the life of the UIT and for five years thereafter.[101]

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94 *Id.* at 230 n.744.

95 Rule 22e-4(b)(1)(iv)(A). As discussed below, there is also a reporting obligation on new Form N-LIQUID.

96 Rule 22e-4(b)(1)(iv)(A).

97 Rule 22e-4(b)(1)(iv)(B).

98 Rule 22e-4(c).

99 Adopting Release, *supra* note 1, at 281.

100 *Id.* at 282.

101 Rule 22e-4(c).

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5. Tailored Liquidity Risk Program Requirements for ETFs

Rule 22e-4 includes certain tailored Liquidity Risk Management Program requirements for ETFs, including ETMFs.[102] These tailored requirements include the following:

a. Highly Liquid Investment Minimum

In-Kind ETFs will not be required to comply with the highly liquid investment minimum provisions of the rule.[103] All other ETFs, including ETMFs that are not In-Kind ETFs,[104] will be subject to the highly liquid investment minimum requirement. While the SEC recognizes that the adoption of a highly liquid investment minimum may introduce tracking errors for index-based ETFs that do not meet redemption requests in kind, the SEC suggests that such ETFs may wish to address and manage this risk through appropriately designed policies and procedures.[105]

An In-Kind ETF generally should describe in its liquidity risk management policies and procedures: (i) how it analyzes the ability to redeem in-kind in all market conditions such that it is unlikely to suddenly fail to continue to qualify for this exclusion to the highly liquid investment minimum requirement; (ii) the circumstances in which it may use a de minimis amount of cash, and what amount of cash would qualify as such; and (iii) how it will manage and/or approve any portion of a redemption that is paid in cash.[106]

b. Liquidity Risk Assessment

ETFs are required to assess, manage, and periodically review their liquidity risk and needs, taking into account, as applicable, the Liquidity Risk Factors that are generally applicable to all funds, but must also consider the following additional factors that are specific to ETFs:

(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[107]

(ii) The effect of the composition of baskets on the overall liquidity of the ETF's portfolio.[108]

c. Portfolio Liquidity Classification

Because In-Kind ETFs transact in kind (and thus do not convert their assets to cash when meeting redemption requests), they are not subject to the portfolio liquidity classification requirement, which is based on the amount of time a fund may take to convert its assets to cash and therefore is not relevant. All other ETFs, including ETMFs, will be subject to the portfolio liquidity classification requirement.

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[102] The Adopting Release notes, however, that certain types of ETFs will not be able to avail themselves of the tailored Liquidity Risk Management Program where the ETF operates as a class of a fund that also has mutual fund classes because, in such cases, the liquidity classification requirement would apply to the entire fund portfolio. Adopting Release, *supra* note 1, at 264 n.846.

[103] Adopting Release, *supra* note 1, at 196 and 225. ETFs that primarily transact in kind but, at times, use more than a de minimis amount of cash to meet redemption requests would not be permitted to rely on this exclusion, although an ETF that delivers cash only on one occasion may be able to conclude that it still qualifies as an In-Kind ETF in later years if such circumstances are not repeated. *Id.* at 266 – 67.

[104] ETMFs choosing not to provide daily transparency would not be permitted to take advantage of the In-Kind ETF exclusion.

[105] Adopting Release, *supra* note 1, at 278.

[106] *Id.* at 267.

[107] Rule 22e-4(b)(1)(i)(D)(i).

[108] Rule 22e-4(b)(1)(i)(D)(ii).

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6. Board Oversight

The Liquidity Risk Management Program requirement of Rule 22e-4 applies to each series of an open-end registered management company (other than money market funds). The primary parties responsible for a fund's liquidity risk management are the fund itself and any parties to whom the fund, through its board of directors/trustees, has delegated responsibility for administering the fund's Liquidity Risk Management Program.

a. Board Approval

A fund will be required to obtain initial approval of its Program from the fund's board, including a majority of the directors or trustees who are not "interested persons" of the fund, as defined in the 1940 Act (the Independent Board Members).[109] In contrast to the proposed rule, a fund's board is not required to approve the highly liquid investment minimum or material changes to the Program. Changes to the highly liquid investment minimum during periods of time in which the fund is below its determined minimum, however, will require board approval, including approval by a majority of the Independent Board Members.[110]

b. Board Review of Report on Adequacy and Effectiveness of Program and on Material Changes

A fund's board, including a majority of the Independent Board Members, will be required to review, no less frequently than annually, a written report prepared by the Liquidity Program Administrator that describes the adequacy and effectiveness of the fund's Program, including, if applicable, the operation of the highly liquid investment minimum, and any material changes to the Program.[111] In a change from the proposal, a fund will not be required to obtain approval of any material changes to the fund's Liquidity Risk Management Program from the fund's board of directors, but instead such material changes will be described in the report.[112]

c. Designation and Board Approval of Liquidity Program Administrator

The fund must designate the fund's Liquidity Program Administrator. The Liquidity Program Administrator cannot be solely one or more portfolio managers of the fund, although portfolio managers can provide input and can be a part of any committee or group designated to administer the Program, if more than one person is so designated.[113] The designation of the Liquidity Program Administrator must be approved by the fund's board, including a majority of the Independent Board Members.[114]

d. Assessment of Plans to Reduce Illiquid Investments

If a fund's illiquid investments are still above 15% of its net assets 30 days from the occurrence (and at each consecutive 30 day period thereafter), the fund's board, including a majority of Independent Board Members, must assess whether the fund's plan to reduce illiquid investments below the 15% threshold continues to be in the best interest of the fund.[115]

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[109] Rule 22e-4(b)(2)(i).

[110] Rule 22e-4(b)(1)(iii)(A)(1).

[111] Rule 22e-4(b)(2)(iii).

[112] Adopting Release, *supra* note 1, at 254 – 55.

[113] *Id.* at 253.

[114] Rule 22e-4(b)(2)(ii).

[115] Rule 22e-4(b)(1)(iv)(B).

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7. Policies and Procedures Regarding Redemptions In Kind

Rule 22e-4(b)(v) requires funds that engage in, or reserve the right to engage in, redemptions in kind, including In-Kind ETFs, to establish policies and procedures regarding how and when they will engage in such redemptions in kind. The Adopting Release provides that well-designed policies and procedures would likely address: (i) the particular circumstances in which a fund might employ in-kind redemptions (e.g., at all times or only under stress); (ii) what types of events may lead the fund to use in-kind redemptions; (iii) whether a fund will use in-kind redemptions for all redemption requests or only requests of a certain size; (iv) how the fund will determine which securities it would use for an in-kind redemption; (v) how the fund addresses and evaluates tax consequences to the fund and redeeming shareholders of distributing certain securities; and (vi) whether the fund plans to redeem securities in kind as a pro rata ratio of the fund's securities holdings or in a non-pro rata manner.[116]

A fund redeeming in a pro rata manner should also address how it plans in-kind redemptions of odd lots or small lots of securities, and illiquid securities or securities having restrictions on their transferability. If the fund were to do an odd lot transaction, its policies and procedures should address how it would process that transaction, and if the fund were to use illiquid securities or securities with restrictions on their transferability, the extent to which these securities would not be redeemed in kind.[117]

Funds not redeeming in a pro rata manner should provide that securities redeemed are selected and distributed in a manner that is fair and does not disadvantage the redeeming or remaining shareholders. If a fund redeems by transferring an unrepresentative set of securities, however, the SEC notes that this may raise questions of discrimination, unfairness and potential cherry picking, all of which should be addressed in a fund's policies and procedures.[118]

III. Disclosure, Reporting and Recordkeeping Requirements

Currently, funds are not expressly required to disclose how they manage the liquidity of their assets. Only limited information is available about whether fund liquidity corresponds to redemption needs. The disclosure and reporting provisions in Rule 22e-4 are designed to provide more transparency and consistency of disclosure about fund liquidity to the SEC. In addition, the SEC believes that the public disclosure requirements outlined below will also help investors make more informed investment decisions.[119] The disclosure and reporting requirements added or amended by the Adopting Release are as follows:

1. Form N-LIQUID

Form N-LIQUID will be applicable to all open-end investment companies, including In-Kind ETFs to the extent applicable, but not money market funds. Such funds will be required to file on a non-public basis a current report when the following events related to the fund's liquidity occur:

- **Reporting of Illiquid Investment Holdings in Excess of the 15% Limitation.** If more than 15% of a fund's net assets are, or become, illiquid investments that are assets, the fund will be required to report within one

[116] Adopting Release, *supra* note 1, at 240-41.

[117] *Id.* at 242-43.

[118] *Id.* at 242.

[119] *Id.* at 45-46.

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business day: (1) the date(s) of the event, (2) the current percentage of the fund's net assets that are illiquid investments that are assets, and (3) identification information about the illiquid investments.

- **Reporting of Compliance with 15% Limitation.** If a fund's illiquid investments that are assets previously exceeded 15% of the fund's net assets and the fund determines that its illiquid investments that are assets have changed to be less than or equal to 15% of its net assets, the fund will be required to report within one business day: (1) the date(s) on which its illiquid investments that are assets fell to or below 15% of net assets, and (2) the current percentage of the fund's net assets that are illiquid investments that are assets.
- **Reporting of Highly Liquid Investment Minimum Shortfall.** A fund will be required to notify the SEC within one business day if its holdings in highly liquid investments that are assets fall below the highly liquid investment minimum for more than seven consecutive calendar days.

2. Amendments to Form N-1A

- **Disclosure of Fund Policies Concerning the Redemption of Fund Shares.** Under an amendment to Item 11 of Form N-1A, a fund (including ETFs and money market funds) will be required to disclose: (1) the number of days following receipt of shareholder redemption requests in which the fund typically expects to pay redemption proceeds to redeeming shareholders; and (2) the methods the fund typically expects to use to meet redemption requests in stressed and non-stressed market conditions (e.g., sales of portfolio assets, holdings of cash or cash equivalents, lines of credit, interfund lending, and/or ability to redeem in kind). In contrast to the Proposing Release, however, funds will not be required to file credit agreements as exhibits to their registration statements.[120]

3. Amendments to Form N-PORT

Amendments to Form N-PORT will require each fund to report the following data on a monthly basis:

- **Highly Liquid Investment Minimum.** A fund will be required to report on Form N-PORT the fund's highly liquid investment minimum, if applicable, and the number of days that the fund's holdings in assets that are highly liquid investments fell below the fund's highly liquid investment minimum during the reporting period. A fund will also be required to report whether its highly liquid investment minimum changed during the reporting period and, if so, to provide any highly liquid investment minimums set by the fund during the reporting period. The information reported for all three months of the quarter will be confidential.
- **Liquidity Classifications for Portfolio Assets.** A fund will be required to report on Form N-PORT the liquidity classification for each portfolio asset. This liquidity classification information will be reported to the SEC in a structured data format on a monthly basis, and information for all three months of the quarter will be confidential. This is in contrast to the original proposal, under which information for the third quarter filing would have been made publicly available after 60 days.
- **Aggregate Percentage of Portfolio Liquidity Classifications.** A fund will be required to report on Form N-PORT the aggregated percentage of its portfolio investments that falls into each of the four liquidity classification categories outlined above. This aggregate information will be disclosed to the public only for the third month of each fiscal quarter with a 60-day delay.

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[120] The definition of "exchange-traded fund" in General Instruction A to Form N-1A will also be amended to conform with the definition under Rule 22e-4, which defines an ETF as an open-end management investment company (or series or class thereof), the shares of which are listed and traded on a national securities exchange, and that has formed and operates under an exemptive order under the 1940 Act granted by the SEC or in reliance on an exemptive rule adopted by the SEC.

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- **Percentages of Highly Liquid Investments Used for Cover.** A fund will be required to disclose the percentages of its highly liquid investments that are segregated to cover, or pledged to satisfy margin requirements in connection with, the fund's derivatives transactions that the fund has classified in the moderately liquid, less liquid, and illiquid investments classification categories. This percentage information will be disclosed to the public only for the third month of each fiscal quarter with a 60-day delay.

4. **Amendments to Form N-CEN**

Amendments to Form N-CEN will require each fund to report the following data on an annual basis:

- **Disclosure of Lines of Credit, Interfund Lending, and Interfund Borrowing.** A fund will be required to disclose information about the availability and use of lines of credit (whether committed or uncommitted), interfund lending, and interfund borrowing during the reporting period. Money market funds will also be subject to the disclosure requirements concerning lines of credit and interfund lending and borrowing.

- **Additional Disclosure for ETFs.** An ETF that complies with Rule 22e-4 as an "In-Kind ETF" must identify itself as such on Form N-CEN.

5. **Recordkeeping Requirements**

Pursuant to Rule 22e-4(b)(3), each fund will be required to maintain the following:

1. A written copy of the fund's Program and any associated policies and procedures (in effect at any time within the past five years), in an easily accessible place;

2. Copies of any materials provided to the fund's board in connection with its approval(s) and written reports on the adequacy of, effectiveness of, and material changes to the Program provided to the board, for at least five years after the end of the fiscal year in which the documents were provided, the first two years in an easily accessible place; and

3. If applicable, a written record of the policies and procedures related to how the highly liquid investment minimum, and any adjustments thereto, were determined, including assessment of the Liquidity Risk Factors and any reports provided to the board in connection with any shortfalls, for a period of not less than five years (the first two in an easily accessible place) following the determination of, and each change to, the highly liquid investment minimum.

IV. Effective and Compliance Dates

Rule 22e-4, Rule 30b1-10, new Form N-LIQUID, and the amendments to Forms N-1A and N-PORT will be effective 60 days after the date of publication in the Federal Register. The amendments to Form N-CEN will be effective on January 1, 2018. Compliance with the new rules and forms will be required as follows.

1. **Adoption of Liquidity Risk Management Program**

The SEC has adopted a phased compliance period to implement the Liquidity Risk Management Program required by Rule 22e-4 (including new Rule 30b1-10 and Form N-LIQUID), which will be based on the asset size of the fund or "group of related investment companies" — defined as two or more management companies (including series thereof) that: (i) hold themselves out to investors as related companies for purposes of investment and investor services; and (ii) either (A) have a common investment adviser or have investment advisers that are affiliated persons of each other or (B) have a common administrator.

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- For larger entities (or groups of related investment companies) with net assets of $1 billion or more at the end of the most recent fiscal year – December 1, 2018; and

- For smaller entities (or groups of related investment companies) with net assets of less than $1 billion – June 1, 2019.

Compliance policies and procedures that satisfy the requirements of Rule 22e-4 must be adopted, implemented and approved by a fund's board on or before the applicable compliance date.

2. Amendments to Form N-1A

The compliance date for amendments to Form N-1A is June 1, 2017.

3. Amendments to Forms N-PORT and N-CEN

The SEC has adopted the following phased compliance period for compliance with the amendments to Forms N-PORT and N-CEN:

- For larger entities – December 1, 2018; and

- For smaller entities – June 1, 2019.

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