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Divided SEC Adopts Significant Changes to Public Liquidity Disclosure Requirements for Open-End Funds; Signals Potential Openness to Considering Alternatives to Prescriptive One-Size-Fits-All "Bucketing" Requirement

I. Introduction and Executive Summary

At an open meeting on June 28, 2018, a divided Securities and Exchange Commission (**"SEC"** or **"Commission"**) made significant changes to the reporting and public disclosure requirements that were adopted in 2016 as part of a package of comprehensive liquidity risk management reforms for open-end funds.[1] While the SEC action left the core 2016 reforms unchanged – in particular new Rule 22e-4, the liquidity risk program rule, and the so-called liquidity "bucketing" or classification requirement of the rule – the SEC also said that its staff will monitor and evaluate the liquidity classification process and data reported to the Commission, and inform the Commission of any recommended further steps.

A. Key Amendments

In the most important change, the Commission voted to replace the original Form N-PORT public classification reporting requirement with a new narrative shareholder report disclosure about the operation and effectiveness of fund liquidity risk management programs. The key elements of this and the other changes adopted at the open meeting (the **"Amendments"**) are:

1. **Elimination of Form N-PORT aggregate liquidity classification reporting.** Under the Amendments, Form N-PORT will not require funds to publicly report aggregated portfolio level liquidity classification information, as would have been required by the Form as originally adopted in 2016.

2. **New narrative shareholder report disclosure.** As a replacement for public reporting of aggregated liquidity classification data, Form N-1A will now require funds to discuss the operation and effectiveness of their Rule 22e-4 liquidity risk management programs over the past year in their annual or semi-annual shareholder reports. In a change from the amendments as proposed,[2] the narrative disclosure will be required in a separate section of the report, following

[1] Investment Company Liquidity Disclosure, Release No. IC-33142 (June 28, 2018), 83 Fed. Reg. 31,859 (July 10, 2018), https://www.federalregister.gov/d/2018-14366 (**"Adopting Release"**).

[2] Investment Company Liquidity Disclosure, Release No. IC-33046 (March 14, 2018), 83 Fed. Reg. 11,905 (Mar. 19, 2018), https://www.federalregister.gov/d/2018-05511 (**"Proposing Release"**).

the contract approval disclosure, instead of in the Management Discussion of Fund Performance (**"MDFP"**) section of the report. In this connection, the Commission also provided guidance on disclosure of liquidity-related events in the MDFP.

3. **Optional multiple classification reporting.** As amended, Form N-PORT will allow funds to report multiple liquidity classification categories for a single position under three specified circumstances.

4. **Disclosure of cash and certain cash equivalents.** A new item on Form N-PORT will require funds to report the amount of their portfolios held in cash and cash equivalents that are not otherwise reported.

B. More to Come – Evaluation of Data and Openness to Classification Exemptive Relief

While the Amendments relate only to reporting and disclosure of liquidity information, the Adopting Release and the public statement of Chairman Jay Clayton indicate an openness to reconsidering the Rule 22e-4 classification requirement itself, as well as possible alternatives to the current requirement, based on the staff's evaluation of classification data after the data for both large and small fund groups for one full year has been received. The staff's evaluation is to include both whether there should be public dissemination of fund-specific liquidity classification information and whether the SEC should propose amendments to Rule 22e-4 to move to a more principles-based approach. The Adopting Release includes a number of questions on which the SEC would welcome public feedback, and the SEC has set up an email inbox, IM-Liquidity@sec.gov, where interested parties may submit information.

Somewhat surprisingly, the Adopting Release raises a new suggestion, which is that funds can submit applications for exemptive relief from the Rule 22e-4 classification requirement, if they have liquidity classification systems in place under their existing liquidity risk management practices that they believe can effectively accomplish the SEC's goals, and where compliance with the Rule 22e-4 classification methodology would result in duplication of effort and wasted resources.

C. Compliance Dates

Compliance with the new shareholder report disclosure requirement will be required for annual or semi-annual reports distributed after December 1, 2019, for large entities (funds in groups with $1 billion or more in assets under management), and after June 1, 2020, for small entities. Compliance with the amendments to Form N-PORT will be required with the filing due July 30, 2019, for large entities, and April 30, 2020, for small entities.

D. An Agency Divided (and Soon to Be Depleted)

The Amendments were adopted at a lengthy open meeting (lasting more than three and a half hours), during which, of the five items voted on, the Commission had split votes on the majority. On two of the items, including the Amendments, the vote was three to two, and was often accompanied by sharply expressed disagreement with the positions taken by others.

Despite the sharp divide on policy matters, there was one issue on which all Commissioners who spoke wholeheartedly agreed, and that was the great loss to the agency that would result from the then imminent departure of Commissioner Michael Piwowar, who retired from the Commission on July 7 of this year, and for whom this was the last open meeting. There was no disagreement that Commissioner Piwowar's leadership, dedication, knowledge, experience, practical sense, and collegiality would be sorely missed.

On a practical note, and looking ahead to the future of Rule 22-4 reform, the Amendments would not have passed but for Commissioner Piwowar's presence and support, and he has been one of the two outspoken proponents of revisiting the Rule 22e-4 classification requirement.

II. Background

A. The 2016 Liquidity Risk Management Reforms – The "Bucketing" Requirement and Form N-PORT Disclosure

On October 13, 2016, the Commission adopted a package of new and amended rules and forms designed to promote effective liquidity risk management programs in the fund industry (the **"2016 Liquidity Reforms"**).[3]

1. The Classification Requirement

The centerpiece of the 2016 Liquidity Reforms was the adoption of new Rule 22e-4, which requires open-end funds (other than money market funds but including exchange-traded funds (**"ETFs"**) (collectively **"funds"**) to adopt formal liquidity risk management programs that are reasonably designed to assess and manage the fund's liquidity risk. Under the terms of the rule, these programs must include five prescribed elements set forth in the Rule.

The most controversial component of Rule 22e-4 has, since the rule was first proposed, been the so-called "bucketing" or classification requirement. This component of the rule, as adopted, requires each fund (other than "In-Kind ETFs")[4] to classify the liquidity of each of the fund's portfolio investments into one of four defined liquidity categories: highly liquid investments, moderately liquid investments, less liquid investments, and illiquid investments, based on the number of days in which the fund reasonably expects the investment to be convertible into cash (or, in the case of the less-liquid and illiquid categories, sold or disposed of) without the conversion significantly changing the market value of the investment. Under Rule 22e-4, the classification determinations must be made using a complex, multi-step methodology prescribed in detail by the rule, which involves a number of assumptions, estimates, and projections, and which prior to the adoption of the rule had not previously been used or tested by the fund industry.[5]

2. Classification Reporting on Form N-PORT

Also on October 13, 2016, the Commission adopted rules to modernize fund reporting, including a new Form N-PORT, which requires funds to report monthly portfolio investment information, among other information, to the Commission in a structured data format. Most of the information reported on Form N-PORT for the third month of each fund's fiscal quarter is made public, 60 days after the end of the quarter.

With respect to liquidity information, Form N-PORT requires funds (other than In-Kind ETFs) to report confidentially to the Commission the liquidity classification assigned to each of the fund's portfolio holdings. As originally adopted, Form N-PORT also required each fund to report the aggregate percentage of its portfolio investments falling into each bucket (which the Adopting Release refers to as the "aggregate liquidity profile"). Unlike the individual classifications, the aggregate liquidity profile for the third fiscal month in the fund's quarter would become public, along with most of the other information in Form N-PORT, 60 days after the end of the quarter.

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[3] Investment Company Liquidity Risk Management Programs, Release Nos. 33-10233, IC-32315 (Oct. 13, 2016), 81 Fed. Reg. 82142 (Nov. 18, 2016) (the **"2016 Adopting Release"**). The 2016 liquidity reforms were adopted as part of a comprehensive agenda for additional regulation of the U.S. fund and asset management industry initiated under the leadership of then Chair Mary Jo White in December 2014. *See* Mary Jo White, Chair, SEC, "Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry," Speech at the *New York Times* DealBook Opportunities for Tomorrow Conference (Dec. 11, 2014), https://www.sec.gov/news/speech/2014-spch121114mjw.

[4] An **"In-Kind ETF"** is defined as an ETF that meets redemptions through in-kind transfers of securities, positions, and assets other than a *de minimis* amount of cash and that publishes its portfolio holdings daily. Rule 22e-4(a)(9).

[5] The other four required components that must be incorporated into Rule 22e-4 liquidity risk management programs are: (1) liquidity risk management ("assessment, management, and review of the fund's liquidity risk"); (2) establishment of a "highly liquid investment minimum" or "HLIM" (the percentage of the fund's assets held in highly liquid investments), together with policies and procedures for responding to a shortfall; (3) codification (with some adjustments) of the current "15% illiquid limit," which prohibits an open-end fund from acquiring illiquid investments once 15% of its assets are illiquid, together with new reporting requirements triggered when the limit is exceeded; and (4) redemption-in-kind procedures regarding how and when funds that reserve the right to redeem in-kind will do so.

B. Lessons Learned During the Implementation Period – Previous Commission Actions

Since adoption of the 2016 Liquidity Reforms, the SEC staff has engaged in extensive outreach to identify potential issues associated with the effective implementation of the rule. Industry participants expressed serious concerns about the unintended consequences of the classification process, as it worked in practice. This outreach resulted in a series of actions taken by the Commission, the latest of which is adoption of the Amendments. These include:

FAQs – The staff has issued guidance intended to assist funds in understanding and complying with the liquidity rule's requirements.[6]

Implementation Delay – On February 22, 2018, the Commission adopted a rule that extends by six months the compliance date for the classification and classification-related elements of the liquidity rule and related reporting requirements.[7]

These actions were aimed at providing investors with accessible and useful information about liquidity risk management of the funds they hold while providing sufficient time for funds to implement the requirement to classify their holdings in an efficient and effective manner.

III. Discussion of the Amendments

A. Public Liquidity Disclosure – Replacement of N-PORT Reporting with Shareholder Report Disclosure

In the most important component of the Amendments, the Commission replaced the requirement in Form N-PORT that a fund publicly disclose on an aggregate basis the percentage of its investments that it has allocated to each liquidity classification category with new narrative discussion in the fund's shareholder report regarding its liquidity risk management program.

The new narrative discussion will include disclosure about the operation and effectiveness of the fund's implementation of its required liquidity risk management program. The new disclosure is expected to complement existing disclosure of liquidity risks – funds already are required to disclose a summary of the principal risks of investing in the fund, including liquidity risk if applicable, in their prospectuses. In addition, the Adopting Release clarifies how funds should discuss liquidity events that materially affected performance in the MDFP section of the annual shareholder report. This clarity, together with the new shareholder report disclosure, is expected to improve funds' disclosure about liquidity events that materially affect fund performance as well as the operation and effectiveness of their liquidity risk management programs.

As described in the Adopting Release:

> These disclosures will provide new and existing investors with a holistic view of the liquidity risks of the fund and how effectively the fund's liquidity risk management program managed those risks on an ongoing basis over the reporting period. This revised approach is designed to provide accessible and useful disclosure about liquidity risks and risk management to investors, with appropriate context, so that investors have a more comprehensive picture of the fund's liquidity risks and their management and may understand the nature and relevance of these risks to their investments.

1. Elimination of Form N-PORT Public Aggregate Liquidity Profile

As originally adopted, Form N-PORT required that a fund publicly disclose on an aggregate basis the

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[6] Investment Company Liquidity Risk Management Programs Frequently Asked Questions, U.S. Securities and Exchange Commission, https://www.sec.gov/investment/investment-company-liquidity-risk-management-programs-faq.

[7] Investment Company Liquidity Risk Management Programs; Commission Guidance for In-Kind ETFs, Release No. IC-33010 (Feb. 22, 2018), 83 Fed. Reg. 8342 (Feb. 27, 2018), https://www.federalregister.gov/d/2018-03917.

percentage of its investments that it has allocated to each liquidity classification category (both the Proposing and Adopting Releases refer to this as the fund's "aggregate liquidity profile").[8]

The amendments eliminate this item from Form N-PORT in response to three general types of concerns raised by industry participants, which the Adopting Release refers to as concerns relating to subjectivity, lack of context, and liquidity risk in isolation.

Subjectivity. Variations in methodologies and assumptions used to conduct liquidity classification can significantly affect the classification information reported on Form N-PORT in ways that investors may not understand;
Lack of context. Form N-PORT may not be the most accessible and useful way to communicate information about liquidity risk and may not provide the necessary context for investors to understand how the fund's classification results relate to its liquidity risk and risk management; and

Liquidity risk in isolation. Because this reporting item on Form N-PORT singles out liquidity risk and does not place it in a broader context of the risks and factors affecting a fund's risk, returns, and performance, it may inappropriately focus investors on one investing risk over others.

The Commission was persuaded that the risks of classification data confusing or misleading investors justified replacing it with narrative shareholder report disclosure. Among other concerns noted by the Commission:

- Subjective information that is presented as quantitative – and thus implies precision and uniformity – raises a significant risk of confusing and misleading investors;

- Public dissemination of the aggregate classification information, without an accompanying full explanation to investors of the underlying subjectivity and assumptions shaping the data, may potentially be misleading to investors who seek an "apples to apples" comparison between funds, and Form N-PORT is not the appropriate vehicle for the level of detail and narrative context that would be necessary for investors to appreciate better the fund's liquidity risk profile and the subjective nature of classification;

- Public dissemination of the aggregate classification information could create perverse incentives to classify investments as more liquid, and may inappropriately highlight liquidity risk compared to other, potentially more salient risks of the fund; and

- Disclosing funds' aggregate liquidity profile may potentially create risks of coordinated investment behavior, if funds were to create more correlated portfolios by purchasing investments that they believed third parties, such as investors or regulators, may view as "more liquid."

Based on these concerns, the Commission concluded that effective disclosure of liquidity risks and their management would be better achieved through prospectus and shareholder report disclosure rather than Form N-PORT. This approach will "avoid use of a one-size-fits-all approach when providing liquidity risk information to investors, and would avoid giving investors the 'false impression that they can rely on the sole results of time bucketing for comparing liquidity of different funds in making their investment decisions.'"

2. New Shareholder Report Liquidity Risk Disclosure

As proposed, the Amendments include a new item in Form N-1A, which will require funds to discuss briefly the operation and effectiveness of a fund's liquidity risk management program in their reports to shareholders. The final form of the new disclosure requirement reflects the comments received. Commenters broadly supported the new requirement – commenters agreed that a narrative discussion of the operation and effectiveness of a fund's liquidity risk management program is a better way to provide investors with useful and accessible liquidity information and reduces the risk of investor confusion, relative to the Form N-PORT aggregate liquidity profile – but suggested adjustments related to placement and timing of the disclosure.

[8] *See* Item B.8.a of Form N-PORT.

Placement. The new disclosure will be required in a new section of the shareholder report (annual or semi-annual) following the discussion of board approval of advisory contracts, instead of in the MDFP section of the annual report, as proposed. The MDFP section of the report requires a discussion of factors that "materially affected the Fund's performance during the most recently completed fiscal year." As a number of commenters pointed out, in many cases the required liquidity disclosures, which relate to operation and effectiveness of the program, would not concern primary drivers of fund performance. Thus the Commission concluded that moving the disclosure about the operation and effectiveness of the liquidity risk management program to a new subsection would be more effective and would avoid concerns about unduly focusing investors on liquidity risk and diluting the MDFP.

Timing. New Item 27(d)(7)(b) of Form N-1A will require funds to discuss the operation and effectiveness of their liquidity risk management program over the past year, in either the annual or semi-annual report, based on whether the board reviewed the program during the fiscal half year covered by the report. Thus funds will have flexibility to cover an annual period that does not coincide with the fund's most recently completed fiscal year. This is intended to ease some of the cost burdens of compliance with the new requirement and improve the effectiveness of the disclosure by allowing funds to synchronize the new shareholder report disclosure with their annual liquidity reporting to the board.

Content of the disclosure. The Adopting Release provides guidance as to how the new disclosure requirement may be satisfied:

- A fund generally may provide information that was provided to the board about the operation and effectiveness of the program, and insight into how the program functioned over the past year.

- The discussion should provide investors with enough detail to appreciate the manner in which a fund manages its liquidity risk.

- The discussion could, but is not required to, include discussion of the role of the classification process, the 15% illiquid investment limit, and the HLIM in the fund's liquidity risk management process.

- As part of this new disclosure, a fund might opt to discuss the particular liquidity risks that it faced over the past year, such as significant redemptions, changes in the overall market liquidity of the investments the fund holds, or other liquidity risks, and explain how those risks were managed and addressed.

- If the fund faced any significant liquidity challenges in the past year, it would discuss how those challenges affected the fund and how they were addressed (recognizing that this discussion may occur in the new subsection or the MDFP, as appropriate).

- In the new subsection, funds also may wish to provide context and other supplemental information about how liquidity risk is managed in relation to other investment risks of the fund.

- Funds can use this disclosure to provide investors with useful empirical data metrics that would be informative of the fund's liquidity profile; this could include empirical data metrics such as the fund's bid-ask spreads, portfolio turnover, or shareholder concentration issues (if any) and their effect on the fund's liquidity risk management.

- The new disclosure item provides funds the opportunity to tailor the disclosure to their specific liquidity risks, explain the level of subjectivity involved in liquidity assessment, and give a narrative description of these risks and how they are managed within the context of the fund's investment strategy.

Overall, the goal of the new disclosure is to provide context and an accessible and useful explanation of the fund's liquidity risk in relation to its management practices and other investment risks as appropriate.

Discussion of Liquidity Events in the MDFP

As discussed above, in addition to the new shareholder report disclosure requirement, funds are required to discuss in their MDFP factors that materially affected performance of the fund during the most recently completed fiscal year. The Adopting Release states that this would include liquidity events to the extent they have a material impact on the fund's performance. The Adopting Release states that the discussion of such liquidity events in the MDFP should include sufficient specificity that investors can understand the liquidity event, how it affected performance, and any other relevant market conditions.

No exemption for highly liquid funds or In-Kind ETFs. The Commission did not accept a recommendation made by several commenters that the new liquidity risk disclosure requirement should not apply to funds that primarily hold assets that are highly liquid investments (**"highly liquid funds"**). While highly liquid funds and In-Kind ETFs are exempt from certain requirements under Rule 22e-4, both categories still must have a liquidity risk management program, and the Commission concluded that investors would benefit from a discussion of the operation and effectiveness of their liquidity risk management programs. The Commission noted, however, that all funds may include "tailored and proportionate discussion appropriate to the liquidity risks they face and the scale of their program." Since the liquidity risks faced by highly liquid funds or In-Kind ETFs may be fewer, or different, than liquidity risks than other funds, the Commission stated that the shareholder report discussion for these types of funds may be proportionate or different than for other funds.

B. Additional Form N-PORT Amendments

1. Multiple Classification Categories

The Commission adopted as proposed amendments to Form N-PORT that will allow funds the option of splitting a fund's holding into more than one classification category in three specified circumstances. The circumstances under which a fund is permitted (although not required) to assign multiple classifications to a single position are:

(1) if portions of the position have differing liquidity features that justify treating the portions separately;[9]

(2) if a fund has multiple sub-advisers with differing liquidity views;[10] or

(3) if the fund chooses to classify the position through evaluation of how long it would take to liquidate the entire position (rather than basing it on the sizes it would reasonably anticipate trading).[11]

Funds using multiple liquidity classifications for a position must indicate the percentage amount of the position attributable to each bucket and which of the three permitted circumstances is applicable.

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[9] For example, where the fund has a put option on a portion but not all of the asset.

[10] The Adopting Release states that allowing a fund to report each sub-adviser's classification of the proportional holding it manages, instead of putting the entire holding into a single category, will avoid the need for costly reconciliation and may provide useful information to the Commission on each sub-adviser's determination about the investment's liquidity.

[11] With respect to the third circumstance, the Commission stated its understanding that some funds may currently use such an approach – classification of their holdings proportionally across buckets, based on an assumed sale of the entire position rather than using the reasonably anticipated trading size or "RATS" approach – for internal risk management purposes. Where that is the case, providing the fund the option of reporting the position assuming a full liquidation on Form N-PORT would be more efficient and less costly than using a single classification category, and will not impair the Commission's monitoring and oversight efforts. While some commenters suggested a change to the proposal that would have permitted proportionality across buckets based on RATS, rather than liquidation of the entire position, the Commission stated its belief that allowing funds to split the reasonably anticipated trade size and use such a split in classifying the rest of a fund's position could further exacerbate these imperfections, leading to more distorted liquidity profiles for funds, and it adopted the scope of this circumstance as proposed. However, the Adopting Release notes that the staff is continuing to evaluate potential other approaches to liquidity risk management, including other approaches to classifying fund liquidity, and that in this context interested parties may provide feedback on the use of RATS as part of classification, and whether the Commission should consider any further modifications.

In circumstances (1) and (2), but not (3), a fund would classify using the reasonably anticipated trade size (**"RATS"**) for each portion of the position.[12]

Prior to this change, Form N-PORT required a fund to classify each holding into a single liquidity bucket. The change reflects the Commission's recognition that the single classification per position requirement poses difficulties for certain holdings, and may not accurately reflect the liquidity of the holding or be reflective of the fund's liquidity risk management practices.

The Adopting Release clarifies that although the change itself amends only Form N-PORT, and not Rule 22e-4, funds may use these classification-splitting approaches not just for Form N-PORT reporting, but for all classification purposes under Rule 22e-4.

Commenters generally supported these proposed amendments to Form N-PORT, noting that they appreciated the flexibility and better accuracy that may result. While a minority of commenters questioned the benefit of the change or expressed the view that permitting multiple classifications of the same position would in fact reduce the utility of the classification process, the Commission concluded that allowing funds to split classifications in the circumstances permitted by the form would enhance the usefulness of the information for its purposes.

> Because funds will be required to indicate which circumstance led to their choice to split a classification, we will be able to identify which positions are split and why. This will allow us a more fine-grained understanding of funds' views of a position's liquidity.

2. Disclosure of Cash and Cash Equivalents

As proposed, the Commission adopted a new Form N-PORT Item that will require registrants to report the dollar amount of their holdings in cash and cash equivalents that are not otherwise reported in Parts C and D of the Form.[13] This information is filed monthly and will be made publicly available each quarter, 60 days after the quarter end.

As explained in the Adopting Release, this new disclosure item is intended to fill a gap left in part by the elimination of the aggregate liquidity profile reporting requirement (discussed above). Form N- PORT as originally adopted does not require registrants to specifically report the amount of cash and cash equivalents held by the registrant.[14] However, cash held by a fund is a highly liquid investment under Rule 22e-4 and would have been included in the aggregate liquidity profile. The Commission expressed concern that "without the aggregate liquidity profile, we may not be able to effectively monitor whether a fund is compliant with its HLIM unless we know the amount of cash held by the fund."

The Commission expects that the additional disclosure of cash and certain cash equivalents by funds "will

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[12] *See* new Item C.7, and the Instructions to this item.

[13] Form N-PORT Item B.2.f. For a definition of cash equivalents, the Adopting Release refers to current U.S. Generally Accepted Accounting Principles, which define cash equivalents as "short-term, highly liquid investments that … are … readily convertible to known amounts of cash … and that are so near their maturity that they present insignificant risk of changes in value because of changes in interest rates." *See* FASB Accounting Standards Codification Master Glossary.

[14] Part C of Form N-PORT requires registrants to report certain information on an investment-by-investment basis about each "investment" held by the registrant, however, cash is not considered an investment for purposes of Form N-PORT, nor are certain types of cash equivalents, and therefore cash and cash equivalents that are not investments are not required to be reported as such in Part C. Part B.1 of Form N-PORT (assets and liabilities), which requires information about a registrant's assets and liabilities, also does not require specific disclosure of a registrant's holdings of cash and cash equivalents. Because, as the Adopting Release notes, certain types of investments that are currently reported in Part C of Form N-PORT "could reasonably be categorized by some registrants as a cash equivalent" (specifically, short term investment vehicles, such as money market funds, liquidity pools, or other cash management vehicles), new Item B.2.f expressly calls for disclosure of only cash equivalents not otherwise reported, "to ensure the amount reported under Item B.2.f is accurate and does not double count items that are more appropriately reported in Parts C (Schedule of portfolio investments) and D (Miscellaneous securities) of Form N-PORT."

provide more complete information to be used in analyzing a fund's HLIM, as well as trends regarding the amount of cash being held, which also correlates to other activities the fund is experiencing, including net inflows and outflows." The additional disclosure item was supported by most of the commenters who addressed it, who agreed that providing this information would help provide a more complete picture of a fund's holdings and assist the Commission's monitoring of a fund's HLIM.[15]

IV. Future Commission Actions on Liquidity Risk Management and Rule 22e-4

A. The Treasury Report and Consideration of Alternative Approaches to Classification

1. Comments on Treasury's "Principles-Based" Classification Recommendation

In the Proposing Release, the Commission noted that in its October 2017 Asset Management and Insurance Report, the Department of the Treasury highlighted the importance of robust liquidity risk management programs, but recommended that the Commission embrace a "principles-based approach to liquidity risk management rulemaking and associated bucketing requirements."[16] The Proposing Release noted that market participants will continue to gather insights as liquidity risk management programs are implemented, and can provide comments to the Commission as they do so. The Proposing Release further stated that the staff will monitor the information received and report to the Commission what steps, if any, the staff recommends in light of commenter experiences.

The Commission specifically requested comment on whether there were advantages to the Treasury report's suggested approach; if so, what additional steps should be taken to shift towards a more principles-based approach; and to what extent have funds already implemented the existing liquidity classification requirement.[17]

In response to this request, the Commission received many comments suggesting alternative approaches to liquidity risk management regulation. A number of these comments were highly critical of the prescriptive, one-size-fits-all nature of the Rule 22e-4 classification. These comments made the following points, among others:

- There is little benefit in the classification provisions of Rule 22e-4, and associated requirements such as the HLIM.
- If the Commission removed the requirements related to classification, or allowed funds to design their own classification systems, funds could define what qualifies as a highly liquid asset and an illiquid asset.
- Several fund groups already have liquidity risk management practices in place that differ from the specific classification requirements of Rule 22e-4, and expect to maintain their own processes alongside those required by the rule; this results in duplication of effort and wasted resources;
- Replacing the classification provisions with a principles-based approach would reduce burdens on funds and investors while still ensuring effective liquidity risk management practices by funds.

On the other hand, other comments noted potential costs in moving to a principles based approach including:

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[15] In response to one commenter that expressed concern about possible investor confusion caused by the requirement to include some but not all cash equivalents in this item, the Commission appreciated the concerns, but believed that the title of the item ("cash and cash equivalents not reported in Parts C and D") will put investors on notice that this item does not necessarily include all cash or cash equivalents held by the fund, and that funds may provide further public explanations about their cash holdings as part of the explanatory notes associated with the items.

[16] Proposing Release, *citing* U.S. Department of the Treasury, *A Financial System That Creates Economic Opportunities: Asset Management and Insurance* 32–35, 153 (Oct. 2017), https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-That-Creates-Economic-Opportunities-Asset_Management-Insurance.pdf.

[17] At the open meeting at which the Commission voted (3–2) to propose the disclosure changes, two Commissioners described the failure to request comment on replacing the classification requirement with a principles-based approach as a missed opportunity.

- limiting the Commission's ability to compare fund reporting in an "apples-to-apples" manner; and

- additional costs associated with moving to such a principles based approach in light of the expense and effort incurred already to comply with the rule.

2. Staff Evaluation of the Classification Requirement and Public Disclosure

On balance, the Adopting Release recognizes that "a broad range of commenters continue to believe that alternative approaches to classification would better achieve the Commission's goals." In response to these comments, during and following the implementation of the rule and reporting requirements, the staff will continue its efforts to monitor and solicit feedback on implementation, including a staff analysis of the extent to which the liquidity classification process and data are achieving the Commission's goals. Following this analysis, the staff will inform the Commission of what steps, if any, the staff recommends in light of this monitoring.

The staff's evaluation of the liquidity classification process and data received is expected to include, at a minimum:

(i) the costs and benefits of Rule 22e-4 and its associated classification requirements;

(ii) whether there should be public dissemination of fund-specific liquidity classification information;

(iii) whether the Commission should propose amendments to Rule 22e-4 to move to a more principles-based approach in light of this evaluation; and

(iv) whether the Commission should propose to require certain empirical data metrics be disclosed.

In terms of timing, the Adopting Release states that the staff evaluation of the classification is expected to take into account at least one full year's worth of liquidity classification data from both large and small entities, in order to allow time for funds and the Commission to gain experience with the classification process, to ground the evaluation on an empirical basis, and to analyze its benefits and costs based on actual practice. The inclusion of small entities in this analysis, for which the first form N-PORTs will not be filed until April 30, 2020 (for the month ended March 1, 2020), means that the evaluation cannot be completed until after the first quarter of 2021.

3. Request for Further Feedback on Classification

The Adopting Release states that the Commission welcomes public feedback as part of this evaluation, and has set up an email inbox where funds, investors, or other interested parties may submit information, now and during the first year of reporting, to help assist the staff and the Commission. In this connection, the Commission asks a number of questions on which it would appreciate information.

The full list of the Commission's questions set out in the Adopting Release is worth careful consideration as a roadmap to areas of potential openness to change, at least on the part of the Commissioners that supported the Release. In terms of possible signals of those Commissioners' concerns with the existing Rule 22e-4 requirements, the following areas identified in the questions may be especially noteworthy:

- Potential duplication of maintaining Rule 22e-4 classification alongside existing separate liquidity risk management processes and practices that funds wish to maintain and related costs;

- Accuracy of the Commission's original cost estimates and assumptions underlying the adoption of the rule, and in particular the assumptions made about vendor usage and associated costs;

- Benefits gained by investors, funds, and the markets from liquidity classification and related provisions (such as the HLIM and the illiquid investment limit), whether these benefits can be retained while moving to a more principles-based system, and whether certain aspects of the classification process, such as the classification of illiquid and/or highly liquid investments, generate greater benefits than others;

- The extent to which investors and others benefit from public liquidity classification information, and other types of information (such as empirical data) that may allow investors to better understand the liquidity of their funds; and

- If the Commission were to propose amendments to Rule 22e-4 to move to a more principles-based approach, whether the benefits of such a new approach would outweigh the costs of implementation, and what the principles should be.

4. Exemptive Relief from Rule 22e-4 Classification

As indicated above, evaluation of a full year of liquidity data will not be completed until 2021, at the earliest. As a result, reconsideration of Rule 22e-4 and possible relief from the classification requirement based on that data will be years in the future, long after funds have fully implemented and operated the Rule 22e-4 classification methodology.

For funds interested in pursuing relief from the Rule 22e-4 classification requirement within a shorter time frame, the Adopting Release offers a suggestion that the Commission and the staff had not previously raised, at least in a public forum, which is the opportunity for individual fund groups to seek exemptive relief from Rule 22-4 classification under Section 6(c) of the Investment Company Act.

> We note that funds that believe they would have to maintain dual liquidity classification programs as part of their liquidity risk management may choose to seek an exemption from the Commission from the classification requirements of Rule 22e-4 if they believe that their existing systems would effectively accomplish the Commission's stated goals.

The Adopting Release does not directly state what form such relief would take, but indicates that the Commission would evaluate appropriate terms and conditions for any exemption under the standard set forth in Section 6(c) of the 1940 Act. That standard requires a Commission finding that the relief sought is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the 1940 Act.

The context of the reference to exemptive relief may also give some indication of what the Commission would find persuasive in such an application. The reference to exemptive relief under Section 6(c) comes at the end of a paragraph where the Adopting Release notes the following points made in one or more comment letters (these are the points, discussed above, made in support of principles-based alternatives, as recommended by the Treasury Report):

- There is little benefit in the classification provisions of Rule 22e-4, and associated requirements such as the HLIM;

- If requirements related to classification were removed or funds were allowed to design their own classification systems, funds could define what qualifies as a highly liquid asset and an illiquid asset;

- Several fund groups already have liquidity risk management practices in place that differ from the specific classification requirements of Rule 22e-4, and expect to maintain their own processes alongside those required by Rule 22e-4, which results in duplication of effort and wasted resources; and

- Replacing the classification provisions with a principles-based approach would reduce burdens on funds and investors while still ensuring effective liquidity risk management practices by funds.

In any case, as indicated in the language quoted above, the application would, at a minimum, need to persuade the Commission that the fund group's existing systems "would effectively accomplish the Commission's stated goals." The Adopting Release does not articulate the stated goals with specificity, but generally refers to the 2016 reforms as designed to enhance the regulatory framework for liquidity risk management of funds, to promote effective liquidity risk management throughout the fund industry, and to enhance disclosure regarding fund liquidity and redemption practices. A more expansive discussion of the Commission's goals can be found in the 2016 Adopting Release, and includes promoting investor protection by reducing the risk that funds will be unable to meet their redemption obligations; increasing the transparency of funds' liquidity risks and risk management practices; mitigating potential dilution of non-transacting shareholders' interests; and modernizing and enhancing the reporting and disclosure of information by funds about the liquidity of their portfolio.

B. Aggregated and Anonymous Report on Data Received

The Adopting Release states that, as discussed in the Proposing Release, the staff anticipates that publishing a periodic report containing aggregated and anonymized information about the fund industry's liquidity may be beneficial. Concerns were raised in the comment process about the value of such a report. As part of the staff evaluation discussed above, the Commission expects the staff will consider whether publishing such aggregated and anonymized classification data would be useful, and will include a recommendation as part of that evaluation as to whether the staff should publish such a periodic report.

V. Effective and Compliance Dates

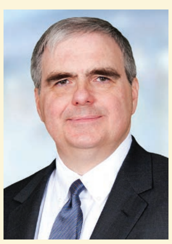
These amendments will become effective 60 days after they are published in the Federal Register. Compliance dates are tiered, based on whether the fund is part of a large or small fund group, according to the schedule below.[18] The final dates reflect a change from the proposal, which had sought to align the compliance date for the amendments to Form N-1A with the revised compliance dates the Commission previously adopted for the liquidity-related portions of Form N-PORT. The final compliance dates provide additional time so that funds have at least a full year's experience with the liquidity risk management program before including the new narrative disclosure in their shareholder report.

FORM N-PORT	**Compliance Date**	**First N-PORT Filing Date**
Large Entities	June 1, 2019	July 30, 2019
Small Entities	March 1, 2020	April 30, 2020
FORM N-1A[19]		
Large Entities	Dec. 1, 2019	
Small Entities	June 1, 2020	

[18] Large entities are defined as funds that, together with other investment companies in the same group of related investment companies, have net assets of $1 billion or more as of the end of the most recent fiscal year. Small entities are defined as funds that, together with other investment companies in the same group of related investment companies, have net assets of less than $1 billion as of the end of the most recent fiscal year.

[19] Funds that distribute annual or semi-annual shareholder reports after these compliance dates will be subject to the new liquidity risk disclosure requirement.

If you would like more information, contact:



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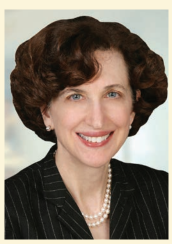

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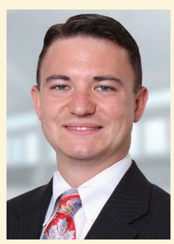

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