SEC Adopts Liquidity Risk Management Rules for Mutual Funds and Exchange-Traded Funds

Skadden

11/03/16

If you have any questions regarding the matters discussed in this memorandum, please contact the following attorneys or call your regular Skadden contact.

Thomas A. DeCapo
Boston
617.573.4814
thomas.decapo@skadden.com

Kenneth E. Burdon
Boston
617.573.4836
kenneth.burdon@skadden.com

Michael K. Hoffman
New York
212.735.3406
michael.hoffman@skadden.com

Kevin T. Hardy
Chicago
312.407.0641
kevin.hardy@skadden.com

This memorandum is provided by Skadden, Arps, Slate, Meagher & Flom LLP and its affiliates for educational and informational purposes only and is not intended and should not be construed as legal advice. This memorandum is considered advertising under applicable state laws.

Four Times Square
New York, NY 10036
212.735.3000

skadden.com

On October 13, 2016, the Securities and Exchange Commission (SEC) voted to adopt Rule 22e-4, Rule 30b1-10 and Form N-LIQUID under the Investment Company Act of 1940 (the 1940 Act), as well as amendments to existing rules and forms. The new and amended rules and forms are designed to enhance and standardize liquidity risk management by mutual funds and ETFs.[1]

Funds in larger fund complexes ($1 billion or more in net assets) must comply with the liquidity risk management requirements on December 1, 2018. Funds in fund complexes with less than $1 billion in net assets have until June 1, 2019, to comply with the new liquidity risk management requirements.

SEC Chair Mary Jo White described these new rules as a "sweeping change for the industry," and it is likely that the new rules will have a far-reaching impact on open-end funds and the industry at large. Implementing or modifying existing liquidity risk management programs and complying with new and frequent disclosure and reporting requirements will involve additional costs for funds and advisers. These new rules also impose significant additional oversight responsibilities on fund boards. They may also have a significant impact on the ability to bring certain investment strategies in an open-end fund structure and, as a consequence, could lead to more frequent use of the closed-end fund structure. Moreover, some existing open-end funds may need to significantly modify their investment strategies or convert to closed-end funds. The long lead time for implementation of these new rules gives funds time to evaluate and make such changes if necessary.

Brief Summary of the New Liquidity Risk Management Rules

The SEC voted to adopt:

- Rule 22e-4, which will require each registered open-end fund, including open-end exchange-traded funds (ETFs) but not money market funds, to establish a liquidity risk management program;
- Rule 30b1-10 and Form N-LIQUID, which will require a fund to notify the SEC when illiquid investments exceed 15 percent of its net assets or when its highly liquid investments fall below its highly liquid investment minimum for more than a specified period of time;
- New sections of Form N-PORT and N-CEN addressing liquidity matters; and
- Amendments to Form N-1A addressing disclosure regarding fund redemption policies.

Liquidity Risk Management Programs

Rule 22e-4, as adopted, requires registered open-end funds, including ETFs but not money market funds, to establish a written liquidity risk management program that is "reasonably designed to assess and manage the fund's liquidity risk," with the fund board's oversight.[2] The final rule further establishes four liquidity classification categories, a highly liquid investment minimum requirement and a 15 percent limitation on funds' purchases of illiquid investments. The SEC also adopted Form N-LIQUID, which will require a fund to confidentially notify the SEC if its illiquid investment holdings exceed 15 percent of its net assets or if its highly liquid investments fall below its highly liquid investment minimum for more than a brief period of time.

[1] Investment Company Liquidity Risk Management Programs, 1940 Act Rel. No. 32315 (Oct. 13, 2016) (Rule 22e-4 Release). For a discussion of the proposed rule, *see* Skadden Client Alert, "SEC Proposes Liquidity Management Rules for Open-End and Exchange-Traded Funds," Oct. 9, 2015.

[2] Rule 22e-4(b). Closed-end funds are excluded from the scope of Rule 22e-4.

SEC Adopts Liquidity Risk Management Rules for Mutual Funds and Exchange-Traded Funds

The requirements for a fund's liquidity risk management program are summarized in detail below.

Liquidity Risk Assessment

Rule 22e-4 requires each fund to assess, manage and periodically review its "liquidity risk," defined as "the risk that a fund could not meet requests to redeem shares issued by the fund without significant dilution of remaining investors' interests in the fund."[3] While similar to the proposed definition, the adopted definition does not include any NAV-impact standard nor direct references to redemption requests expected under normal conditions or that are reasonably foreseeable under stressed conditions. The SEC emphasizes, however, that a conceptual link between liquidity and sale price in the definition of "liquidity risk" remains appropriate because it believes that impacts on valuation may play a significant role in evaluating a fund's ability to effectively meet shareholder redemptions while lessening the effects of dilution. The SEC explains that "significant" in this context is not meant to reference slight NAV movements, the causes of which may not be easily distinguishable, nor is it limited only to "fire-sale" situations. The key focus is the fund's ability to meet redemptions in a manner that does not harm shareholders.

The rule requires a fund's liquidity risk management program to include policies and procedures reasonably designed to incorporate the following elements (Liquidity Assessment Factors), as applicable. A fund is permitted to incorporate additional considerations if it so desires. Additionally, a fund must periodically review, at least annually, its liquidity risk, taking into account the Liquidity Assessment Factors.[4]

Investment Strategy, Portfolio Liquidity and Appropriateness for the Open-End Structure. A fund must consider its "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."[5] The principal change here from the proposed rule is the requirement to consider whether the investment strategy is appropriate for an open-end fund. Among other issues, the SEC points out that this requirement will cause funds to evaluate both the suitability of investment strategies that will be permitted under the 15 percent illiquid investment limit — which has been significantly tightened, as described below — and the challenges that they might face with significant holdings of securities with extended settlement periods in view of their obligations to meet redemptions within seven days (particularly if the fund has not established adequate other sources of liquidity).

The Rule 22e-4 Release candidly recognizes that this requirement might lead a fund to reconsider its continued operation as an open-end fund. Notably, however, the Rule 22e-4 Release does not suggest what an existing fund might do in such a situation, except to state in a footnote that "actions that either directly or indirectly extinguish the rights of shareholders to redeem their shares could, depending on the facts and circumstances, involve violations of section 22(e) and other provisions of the [1940] Act, such as section 48(a) (prohibiting a person from doing indirectly, through another person, what that person is prohibited by the [1940] Act from doing directly)."[6] For an existing fund, the primary choices are to significantly change its investment strategies, liquidate or convert to a closed-end structure. Depending on the fund's governing and disclosure documents, all of these options could require a shareholder vote. While seeking shareholder approval to convert from an open-end fund to a closed-end fund and thereby forego a certain amount of liquidity at NAV is virtually unprecedented, if shareholders are faced with a choice of losing access to an investment strategy or accepting periodic or exchange-based liquidity, some shareholders may well vote to convert to closed-end fund status.

The SEC also notes that its staff could "request information from the fund regarding the fund's basis for determining that its investment strategy is appropriate for the open-end structure" in the registration statement review process for both initial registration statements and post-effective amendments.[7] This appears to portend the SEC staff seeking to put new and existing funds on record as to why they think their open-end structure is appropriate and potentially effectively blocking certain new funds from being brought in an open-end structure. Such SEC staff attention would likely be targeted at the types of strategies repeatedly identified in the Rule 22e-4 Release as concerning to the SEC in the open-end structure: certain types of fixed-income strategies, alternative strategies and potentially certain types of equity strategies. As a result, there should be a heavier focus by funds, advisers and boards on the appropriateness of a strategy for an open-end structure and consideration of whether alternative structures may be more suitable for a particular strategy.

Cash Flow Projections. The fund must consider "[s]hort-term and long-term cash flow projections during both normal and reasonably foreseeable stressed conditions."[8] Here, the principal change from the proposed rule is the removal of a codification

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

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

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

[6] Rule 22e-4 Release, at n.209.

[7] Rule 22e-4 Release, at n.206.

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

of various factors to consider in evaluating this element. Rather, the SEC determined to include these factors as "guidance" in the Rule 22e-4 Release. These factors are: (1) the size, frequency and volatility of historical purchases and redemptions of fund shares during normal and reasonably foreseeable stressed periods, (2) the fund's redemption policies (with an emphasis on the "advertised" time for paying redemption proceeds), (3) the fund's shareholder ownership concentration, (4) the fund's distribution channels and (5) the degree of certainty associated with the fund's short-term and long-term cash flow projections. The SEC's guidance places particular emphasis on attempting to understand the composition of a fund's shareholder base in order to better predict fund flows in response to market events or fund performance.

Liquidity Sources. The fund must consider "[h]oldings of cash and cash equivalents, as well as borrowing arrangements and other funding sources."[9]

Liquidity Classification

A fund must classify each of its portfolio investments, including its derivative transactions, based on the number of days in which the fund would reasonably expect to be able to convert the asset into cash (or, in the case of the less-liquid and illiquid categories, sell or dispose of it) without significantly changing its market value.[10] "Convertible to cash" means a settled sale transaction.[11] The classification categories are:

- *Highly Liquid Investments:* cash and any investment reasonably expected to be converted to cash in current market conditions in **three business days or less** without the conversion to cash significantly changing the market value of the investment.[12]
- *Moderately Liquid Investments:* any investment reasonably expected to be converted to cash in current market conditions in **more than three calendar days but in seven calendar days or less** without the conversion to cash significantly changing the market value of the investment.[13]
- *Less Liquid Investments:* any investment reasonably expected to be sold or disposed of in current market conditions in **seven calendar days or less** without the sale or disposition significantly changing the market value of the investment, but where the sale or disposition is reasonably expected to settle in more than seven calendar days.[14]
- *Illiquid investments:* any investment that may not reasonably be expected to be sold or disposed of in current market conditions in seven calendar days or less without the sale or disposition significantly changing the investment's market value.[15]

These classification categories represent a change from the proposed rule and appear responsive to industry feedback seeking a more workable approach to liquidity classification. These classifications also inform the basis for the highly liquid investment minimum and the 15 percent illiquid investment limit, both discussed below.

Liquidity Classification Factors. In classifying investments, a fund is required to consider relevant "market, trading, and investment-specific considerations."[16] This is another change from the proposed rule, which sought to codify a list of factors to consider in making liquidity classifications. In response to industry feedback, the final rule adopts this principles-based requirement. The SEC, however, has retained a discussion of various classification factors as "guidance" in the Rule 22e-4 Release.[17] These factors are non-exhaustive and are as follows:

- the existence of an active market for an asset class or investment, especially the exchange-traded nature of an asset class or investment;
- frequency of trades or quotes and the average daily trading volume;
- volatility of trading prices;
- bid-ask spreads;
- whether the asset has a relatively standardized and simple structure;
- maturity and date of issue of fixed income securities; and
- restrictions on trading certain investments, as well as limitations on an investment's transfer.

In yet another change from the proposed rule, the final rule permits a fund to classify its portfolio investments based on asset class, so long as the fund or its adviser, after reasonable inquiry, does not have market, trading or investment-specific information that is reasonably expected to significantly affect the liquidity characteristics of an investment as compared to the fund's other portfolio holdings within that asset class.[18] This change also was in response to industry feedback. However, it is notable that the Rule 22e-4 Release describes classification by asset class "as a starting point"[19] and then continues to assert that "reasonably

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

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

[11] Rule 22e-4(a)(3).

[12] Rule 22e-4(a)(6).

[13] Rule 22e-4(a)(12). Note that in the case of a business day/calendar day mismatch as between the highly liquid and moderately liquid categories, a fund can classify the investment as a highly liquid investment. For example, if you reasonably expect to be able to settle a sale made on a Thursday on a T+3 basis.

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

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

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

[17] Rule 22e-4 Release, at 160-73.

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

[19] Rule 22e-4 Release, at 133.

designed policies and procedures would likely include specifying the sources of inputs that inform [a fund's] exception processes ... as well as particular variables that could affect the fund's classification of certain investments."[20] In short, while position-level classification is not required outside of the exception-based scenario described in the final rule, the SEC expects funds to have a process to consider liquidity factors impacting individual investments. The Rule 22e-4 Release also makes clear that a fund's asset-class-based classification procedures should incorporate sufficient detail to meaningfully distinguish between asset classes and sub-classes, and that general asset class categories — such as "equities," "fixed income" and "other" — would not be appropriate.[21]

A fund also must consider whether the conversion of an investment to cash (or, in some cases, the investment's sale or disposition) would significantly change the market value of the investment.[22] According to the SEC, this "highlights that the standard does not require a fund to actually revalue or reprice the investment for classification purposes, nor does the standard require the fund to incorporate general market movements in liquidity determinations or estimate market impact to a precise degree."[23] This standard requires a fund to consider the market value impact of a hypothetical sale of an investment and is designed to remove any confusion that this value impact standard incorporates general market movements that would occur between when a fund strikes its NAV and when it trades the investment.[24] This standard is related to the SEC's overarching theme for this rule, which is to seek to mitigate the risk that a fund could only meet redemption requests in a manner that significantly dilutes the fund's non-redeeming shareholders. The SEC also asserts that "a fund's classification policies and procedures should address what it would consider to be a significant change in market value."[25] As to what is a "significant change," it is notable that the proposed rule contained a standard of "materially affecting" the value of the asset immediately prior to sale. According to the SEC, it believes that funds will be less likely to interpret "significant changes" in market value as capturing very small movements in price.[26] Similarly, as discussed above this standard is not meant to capture general market movements and is designed to capture the risk of dilution in cases of inadequate liquidity, while not also requiring funds to account for every possible value movement.[27]

A fund must further evaluate an investment's market depth in making liquidity classifications. Specifically, a fund is required to determine whether trading varying portions of a position in a particular portfolio investment, in sizes that the fund would reasonably anticipate trading, is reasonably expected to significantly affect the liquidity characteristics of that investment.[28] This requirement would have a fund consider portions of a portfolio position that are larger than a single trading lot, but not necessarily the position's full size, in assessing its portfolio investments' liquidity. If the fund determines that a downward liquidity adjustment is appropriate as a result of this analysis of market depth, that new classification would apply to the entirety of the fund's position in that investment (not, as proposed, to portions of that position).[29]

Periodic Review of Liquidity Classifications. Under Rule 22e-4, the fund must also review each portfolio investment's classification at least monthly in connection with reporting the classification(s) on Form N-PORT on a confidential basis, and more frequently if changes in the relevant market, trading and investment-specific considerations would reasonably be expected to materially affect the classification(s).[30] This, in combination with the classification standard of "in current market conditions," contemplates that liquidity classifications may change (including more frequently than monthly), which, depending on the state of the markets, could have significant impacts under the final rule. For example, a fund may classify an asset in one liquidity category in normal circumstances. However, in extremely stressed market conditions, that same asset could quickly need to be downgraded to a less liquid category. This downgrade could result in breaches of a fund's highly liquid investment minimum and the 15 percent illiquid investment limit (both discussed below), together with virtually immediate reporting obligations to the SEC (also discussed below).

Issues Regarding Derivatives. A fund must classify its derivatives transactions by liquidity as well. For derivative transactions classified as moderately liquid, less liquid or illiquid, the fund must identify, and disclose in its Form N-PORT filings, the percentage of its highly liquid investments it has segregated to cover such transactions; this information will be part of

[20] Rule 22e-4 Release, at 137.

[21] Rule 22e-4 Release, at 136-37. The Rule 22e-4 Release also discusses the SEC's expectation that any third-party service providers used to help assist in assessing liquidity classifications would be overseen by the administrator of the fund's liquidity risk management program. See Rule 22e-4 Release, at 103-04.

[22] The Rule 22e-4 Release clarifies that the term "market value" as used in this context includes the value of investments that are fair valued. *See* Rule 22e-4 Release, at n.325.

[23] Rule 22e-4 Release, at 104.

[24] Rule 22e-4 Release, at 109.

[25] Rule 22e-4 Release, at 108.

[26] Rule 22e-4 Release, at 107.

[27] Rule 22e-4 Release, at 108.

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

[29] Rule 22e-4 Release, at 138-42.

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

publicly available N-PORT information.[31] A fund is not, however, required to identify which of its particular assets have been segregated to cover these derivative transactions.

Illiquid Investments and 15 Percent Illiquid Investment Limit

The final rule significantly changes existing SEC guidance regarding the identification of illiquid investments, and thus the determination of whether a fund is in compliance with the 15 percent limit on illiquid investments. Rule 22e-4, as adopted, prohibits funds from acquiring any illiquid investment if, immediately after the acquisition, the fund would have invested more than 15 percent of its net assets in illiquid investments.[32] This basic standard is consistent with existing and historical SEC guidance. However, the manner in which a fund must identify illiquid investments has significantly changed.

Under historical SEC guidance, which the Rule 22e-4 Release withdraws, and the proposed rule, funds were not required to take into account any specific market or other factors, or assess position size as it could reflect market depth, in determining whether they could sell an asset within seven days without the specified value impact for purposes of determining whether an investment was illiquid in applying the 15 percent illiquid investment limit. The final rule, unlike the proposed rule, does not have a separate process for determining whether an investment is illiquid for purposes of the 15 percent illiquid investment test — funds must apply the same analysis described above and, in applying that analysis, if more than 15 percent of a fund's net assets are illiquid investments, it cannot acquire any additional illiquid investments ***and*** **it must engage in remedial measures and report to its board and the SEC**.

The Rule 22e-4 Release candidly recognizes that the result of this new definition may be that some funds take into account relevant market, trading and investment-specific considerations, as well as market depth, for the first time and therefore may determine that a greater percentage of holdings are illiquid. The Rule 22e-4 Release also recognizes that this could cause certain funds to modify their investment strategies or reconsider their structure as open-end funds.[33] This, in combination with the requirement to consider whether an investment strategy is appropriate for an open-end fund, could have a significant impact on both existing and new products and lead to greater use of the closed-end fund structure.

A fund is required to notify its board and report confidentially to the SEC on the newly adopted Form N-LIQUID within one business day of its illiquid investments exceeding the 15 percent illiquid investment limit.[34] In reporting to the board, the administrator(s) of the liquidity risk management program must explain the extent and cause of the occurrence, as well as articulate a plan for restoring the threshold within a reasonable period of time. If a breach of the 15 percent illiquid investment limit is ongoing for 30 days (and at each consecutive 30 day period thereafter), the fund's board, including the independent board members, must assess whether the plan presented to it continues to be in the best interests of the fund. Importantly, however, the final rule does not expressly require a fund to divest holdings within any stated period of time if illiquid investments exceed 15 percent of its net assets. Rather, the final rule seeks to prohibit funds from exceeding the 15 percent limit on illiquid investments for an extended period of time without board oversight.[35] Also, neither the SEC's guidance nor the final rule places the responsibility for determining whether a specific security is liquid or illiquid on the fund's board.[36]

Highly Liquid Investment Minimum

Any fund that does not primarily hold assets[37] that are highly liquid investments must establish and periodically review (at least annually) a "highly liquid investment minimum," defined as the minimum amount of the fund's net assets that the fund invests in highly liquid investments.[38] The Rule 22e-4 Release asserts that "if a fund held less than 50% of its assets in highly liquid investments, it would be unlikely to qualify as 'primarily' holding assets that are highly liquid investments."[39]

In establishing its highly liquid investment minimum, the fund must consider the Liquidity Assessment Factors described

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

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

[33] Rule 22e-4 Release, at 132.

[34] Funds also must report to the SEC on Form N-LIQUID within one business day of coming back into compliance with the 15 percent illiquid investment limit.

[35] *See* Rule 22e-4 Release, at 236.

[36] Rule 22e-4 Release, at 127.

[37] The SEC notes that it refers to highly liquid investments that are "assets" to make clear that when evaluating whether a fund is meeting its highly liquid investment minimum, the fund should look to its investments with positive values — highly liquid investments that have negative values should not be netted against highly liquid investments that have positive values. Thus, only highly liquid investments that have positive values (*i.e.*, "assets") should be used in the numerator. See Rule 22e-4 Release, at n.633. A similar concept also applies in respect of the 15 percent illiquid investment limit. See Rule 22e-4 Release, at n.744.

[38] Rule 22e-4(b)(1)(iii). Recall that a "highly liquid investment" is defined as cash and any investment reasonably expected to be converted to cash in current market conditions in **three business days or less** without the conversion to cash significantly changing the market value of the investment.

[39] Rule 22e-4 Release, at n.726. The Rule 22e-4 Release also notes that the SEC anticipates that a primarily highly liquid fund would address in its liquidity risk management program how it determines that it primarily holds assets that are highly liquid investments, including, for example, how it defines "primarily." See Rule 22e-4 Release, at 225.

above.[40] The fund also must adopt and implement policies and procedures for responding to a highly liquid investment minimum shortfall, which would include reporting any shortfall to the board no later than the board's next regularly scheduled meeting and providing a brief explanation of the causes and extent of the shortfall, as well as any remedial actions taken.[41] If the highly liquid investment minimum shortfall lasts more than seven consecutive calendar days, the fund must, within one business day, report to its board with an explanation of how the fund plans to restore its minimum within a reasonable period of time, and report confidentially to the SEC on new Form N-LIQUID.[42]

The basic framework of this requirement is the same as in the proposed rule. The SEC did, however, scale back the fund board's involvement. Unlike the proposed rule, under the final rule the fund's board is not required to specifically approve the highly liquid investment minimum and changes thereto. The one exception to this general rule is during a period in which highly liquid investments are below the established minimum — in that circumstance, the minimum can be changed only with board (including independent board member) approval.[43] This permits the fund to seek to manage its highly liquid investment minimum dynamically taking into account the Liquidity Assessment Factors as market and other conditions change. In another change from the proposed rule, the final rule does not limit the liquidity of investments a fund can acquire when its highly liquid investments fall below the established highly liquid investment minimum (the proposed rule had prohibited acquisition of assets other than highly liquid investments when facing a highly liquid investment minimum shortfall).[44] Rather, the highly liquid investment minimum shortfall policies and procedures, discussed above, are intended to replace this requirement from the proposed rule.

Like with the definition of illiquid investment and the related 15 percent illiquid investment limit, the Rule 22e-4 Release also candidly recognizes that certain funds with relatively less liquid portfolios could find it difficult to comply with this aspect of the final rule and, after consideration of the Liquidity Assessment Factors, cause a fund to modify its investment strategy if it were to determine it is appropriate to invest in higher amounts of highly liquid investments.[45]

The final rule requires a fund to periodically, but no less than annually, review its highly liquid investment minimum.[46] Related to this, and in a change from the proposed rule, the final rule specifies that only those stressed conditions that are reasonably foreseeable during the period until the next review of the highly liquid investment minimum should be considered in establishing the highly liquid investment minimum.[47] This was revised in response to concerns that the proposed rule would lead all funds to hold a high level of cash and other highly liquid investments at all times irrespective of liquidity risk.

Additionally, a fund other than a "primarily highly liquid fund" is required to report its highly liquid investment minimum on Form N-PORT to the SEC on a confidential basis. Other amendments to Form N-PORT also require that if the minimum changes during the reporting period, any prior minimums established by the fund during the reporting period must also be reported. In addition, if the fund experienced a shortfall, it must report the number of days it fell below the minimum during the reporting period.

Redemptions in Kind

Rule 22e-4 requires a fund that engages in or reserves the right to engage in in kind redemptions to adopt and implement written in-kind redemption policies and procedures as part of its liquidity risk management program.[48] This requirement is largely unchanged from the proposed rule. These written policies and procedures should address the circumstances under which the fund would consider redeeming in kind and the process for redeeming in kind.[49] In the Rule 22e-4 Release, the SEC provided guidance on designing effective policies and procedures for this purpose and suggested various topics that such policies and procedures might address, including:

- whether a fund would use in-kind redemptions at all times or only under stress, and what types of events may lead a fund to use them;
- whether a fund would use in-kind redemptions for all requests or only requests over a certain size;
- the ability of investors to receive in-kind redemptions and potentially different procedures for different shareholder types;
- potential operational issues with providing in-kind redemptions to various kinds of investors; and
- how the fund would determine which securities it would use and whether it would redeem on a pro-rata or non-pro rata basis.[50]

[40] Rule 22e-4(b)(1)(iii)(A)(1). The Rule 22e-4 Release makes clear the SEC's view that it would be extremely difficult for a fund to conclude that a highly liquid investment minimum of zero would be appropriate. *See* Rule 22e-4 Release, at 213.

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

[42] *Id.*

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

[44] Rule 22e-4 Release, at 197.

[45] Rule 22e-4 Release, at 202.

[46] Rule 22e-4(b)(1)(iii)(A)(2).

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

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

[49] *Id.*

[50] Rule 22e-4 Release, at 240-41.

SEC Adopts Liquidity Risk Management Rules for Mutual Funds and Exchange-Traded Funds

Board Approval and Review

The final rule seeks to put the board in an oversight position with respect to a fund's liquidity risk management program. This is in contrast to the more specific and detailed board approval requirements in the proposed rule. Under Rule 22e-4, the board, including a majority of the independent board members, must approve (1) the investment adviser, officer or officers (who cannot solely be portfolio managers of the fund) who are responsible for administering the liquidity risk management program, and (2) the written liquidity risk management program.[51] In initially approving a fund's liquidity risk management program, the board may satisfy its obligations by reviewing summaries of the program prepared by the fund's investment adviser, officer or officers administering the program, legal counsel or other persons familiar with the liquidity risk management program.[52] This process is consistent with requirements for approving compliance policies and procedures generally under Rule 38a-1 of the 1940 Act.

The board, including a majority of the independent board members, must also review, at least annually, a written report, prepared by the program administrator, that addresses the operation of the program and assesses its adequacy and effectiveness of implementation, including, if applicable, the operation of the highly liquid investment minimum and any material changes to the program.[53] The final rule does not require the board to approve material changes to the liquidity risk management program or changes to the highly liquid investment minimum (other than in the case of a change sought during a shortfall in the highly liquid investment minimum).

The chart below summarizes the board's obligations.

Recordkeeping

Rule 22e-4 imposes recordkeeping requirements on funds.[54] Each fund is required to maintain:

- a written copy of the policies and procedures relating to its liquidity risk management program;
- copies of any board materials relating to the board's initial approval and review of the program;
- copies of any board materials relating to drops below the fund's highly liquid investment minimum; and
- a written record of the policies and procedures related to how the highly liquid investment minimum, and any adjustments thereto, were determined.

Board Action	Board Reports
- Approve an administrator for the liquidity risk management program. - Approve the initial written liquidity risk management program. - Approve changes to the highly liquid investment minimum during a shortfall. - If a breach of the 15% illiquid investment limit is ongoing for 30 days (and at each consecutive 30-day period thereafter), assess whether the plan presented to it to cure the breach continues to be in the best interests of the fund.	- Board must review, at least annually, a written report prepared by the program administrator that: 1. Addresses the operation of the program and assesses its adequacy and effectiveness of implementation; 2. Addresses any material changes to the program; and 3. Addresses the operation of the highly liquid investment minimum (if applicable). - Within 1 business day, the program administrator must report a breach of the 15% illiquid investment limit, together with an explanation of the extent and causes of the occurrence, and how the fund plans to cure the breach within a reasonable period of time. - At next regularly scheduled meeting, the program administrator must report any highly liquid investment minimum shortfalls that occurred, together with an explanation of the causes of the shortfall, the extent of the shortfall and any actions taken in response. - Within 1 business day after a highly liquid investment minimum shortfall has lasted more than 7 consecutive calendar days, the program administrator must report to the board with an explanation of how the fund plans to restore its minimum within a reasonable period of time.

[51] Rule 22e-4(b)(2)(i) and (ii). See Rule 22e-4 Release, at 251-54.

[52] Rule 22e-4 Release, at 249-50.

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

[54] Rule 22e-4(b)(3).

ETFs

In a change from the proposed rule, and in response to industry feedback, the final rule exempts certain ETFs that qualify as "In-Kind ETFs" from the new liquidity classification requirement and highly liquid investment minimum requirement. 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.[55] An "ETF" is defined 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.[56] The Rule 22e-4 Release explains the SEC's expectation that In-Kind ETFs will incorporate considerations regarding its redemption practices and the de minimis nature of any cash used to fund redemptions into its written policies and procedures for its liquidity risk management program.[57]

The final rule also imposes on all ETFs two tailored liquid risk management program requirements. ETFs must consider, along with the Liquidity Assessment Factors discussed above, the following additional factors (as applicable) when assessing the ETF's liquidity risk:

- 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);
- the effect of the composition of baskets on the overall liquidity of the ETF's portfolio;[58] and
- any other consideration(s) that the ETF deems appropriate.[59]

Disclosure and Reporting Requirements Resulting From Rule 22e-4

Form N-LIQUID

Under newly adopted Rule 30b1-10, open-end funds, including In-Kind ETFs to the extent applicable but not including money market funds, must file a report on new Form N-LIQUID when certain events relating to the fund's liquidity occur. Information reported on Form N-LIQUID will be nonpublic. Specifically, a registrant is required to notify the SEC within one business day (1) when more than 15 percent of a registrant's net assets are or become illiquid investments; (2) if a registrant whose illiquid investments previously exceeded 15 percent of its net assets determines that such holdings have fallen to 15 percent or below; or (3) if its holdings in highly liquid investments that are assets fall below its highly liquid investment minimum for more than seven consecutive calendar days.

Amendments to Form N-PORT

A fund is required to report the liquidity classification of each of its portfolio investments (which may be by asset class, subject to the exception process described above), including its derivative transactions, on Form N-PORT, along with (as applicable) information about its highly liquid investment minimum. This information will not be public.

Further, a fund is required to report, as applicable, (1) the percentage of its highly liquid investments that is segregated to cover the fund's derivative transactions in each of the other liquidity categories, and (2) the aggregated percentage of its portfolio investments that falls into each of the liquidity classification categories. These items will be made publicly available for the third month of each fiscal quarter with a 60-day delay, consistent with the general public availability of Form N-PORT information.

Amendments to Form N-1A

The SEC adopted amendments to Form N-1A that will require open-end funds, including money market funds and ETFs, to (1) further describe its redemption procedures, including the number of days following receipt of a shareholder redemption request in which the fund typically expects to pay redemption proceeds; and (2) describe the methods the fund typically expects to use to meet redemption requests in stressed and non-stressed market conditions. Note that the compliance date for these amendments to Form N-1A is June 1, 2017, for all registrants.

Notably, neither the final rule nor the Rule 22e-4 Release addresses whether or when the existence of one of the liquidity-based shortfalls contained in the final rule is material in the context of public disclosures for open-end funds conducting continuous public offerings of their securities. These materiality decisions would need to be made on a case-by-case basis by funds and their boards. The promulgation of this new rule, together with its emphasis on reporting specific liquidity-based shortfalls to fund boards and to the SEC on a confidential basis, raises interesting disclosure dynamics in the context of open-end funds conducting continuous public offerings. It may be prudent for open-end funds to consider adding standing disclosure to

[55] Rule 22e-4(a)(9).

[56] Rule 22e-4(a)(4). Thus, for example, this definition does not cover an ETF organized as a unit investment trust (UIT). UITs are not covered by the liquidity risk management program requirements in Rule 22e-4; rather, Rule 22e-4(c) imposes the following requirement on UITs: "On or before the date of initial deposit of portfolio securities into a registered UIT, the UIT's principal underwriter or depositor must determine that the portion of the illiquid investments that the UIT holds or will hold at the date of deposit that are assets is consistent with the redeemable nature of the securities it issues, and must maintain a record of that determination for the life of the UIT and for five years thereafter."

[57] Rule 22e-4 Release, at 264-68.

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

[59] Rule 22e-4 Release, at 270.

their offering documents that emphasizes the new liquidity-based tests contained in the final rule and explains that, from time-to-time, the fund might not be in compliance with these tests and that such noncompliance is reported to the fund's board and/or the SEC on a confidential basis and that, ordinarily, the fund would not make public disclosure of noncompliance with these tests except in extreme circumstances.

The SEC also did not adopt a proposed requirement to file credit agreements as an exhibit to Form N-1A. Notably, the SEC appears to agree with the view that Form N-1A does not otherwise require the filing of a fund's credit agreements notwithstanding Item 28(h) of Form N-1A, which requires the filing of material contracts not made in the ordinary course of business as exhibits to Form N-1A.

Amendments to Form N-CEN

The SEC adopted several reporting items under Part C of Form N-CEN, including requiring (1) a management company to report information regarding its use of lines of credit, interfund lending and interfund borrowing, and (2) In-Kind ETFs to identify themselves as such in the form.

Skadden's Investment Management Group regularly assists clients in analyzing and implementing new regulatory requirements.

Michelle Huynh, an Investment Management Group associate in the Boston office, contributed to this client alert.