SEC DELAYS CERTAIN LIQUIDITY RULE REQUIREMENTS AND ISSUES GUIDANCE REGARDING ILLIQUID SECURITY DETERMINATIONS

Date: 10 April 2018

U.S. Investment Management Alert

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On February 22, 2018, the Securities and Exchange Commission ("SEC") adopted an interim rule ("Interim Rule") [1] that revised compliance dates for certain provisions of Rule 22e-4 under the Investment Company Act (the "Liquidity Rule") and related requirements. [2] The Liquidity Rule requires each fund [3] to adopt and implement a written liquidity risk management program reasonably designed to assess and manage its liquidity risk. A major compliance obligation under the Liquidity Rule is that each fund, except for ETFs that pay redemptions in-kind, must classify the liquidity of its portfolio investments and review those classifications at least monthly ("portfolio classification"). [4] The Interim Rule delays for six months the compliance date for the portfolio classification requirements and other regulatory and reporting obligations relating to portfolio classification. [5] The Interim Rule also contains guidance for In-Kind ETFs [6] and other funds that do not have to engage in full portfolio classification. The compliance deadline extensions and the guidance are discussed further below.

SIX-MONTH COMPLIANCE DATE EXTENSIONS

The Interim Rule extends for six months the compliance date for the Liquidity Rule provision that requires funds to classify the liquidity of their investments. Thus, "larger entities" are required to comply with the rule's provision by June 1, 2019, [7] and "smaller entities" are required to comply with the rule's provision by December 1, 2019. In particular, the Interim Rule delays the following:

1. Full portfolio classification - Rule 22e-4(b)(1)(ii);
2. Determination of a highly liquid investment minimum ("HLIM") - Rule 22e-4(b)(1)(iii);
3. Portfolio classification and HLIM reporting requirements of Forms N-PORT (Items B.7 - HLIM, B.8 - Classification aggregates, and C.7 - Classification information) and N-LIQUID (Part D - HLIM matters);
4. Recordkeeping requirements relating to portfolio classification (Rule 22e-4(b)(3)(i)) and HLIM (Rule 22e-4(b)(3)(iii)); and
5. Board approval (Rule 22e-4(b)(2)(i)) and related annual board review (Rule 22e-4(b)(2)(iii)) of the fund's liquidity risk management program.

The Interim Rule release also provides insights about how the fund industry is implementing the Liquidity Rule. Among other matters, the SEC noted that, contrary to what it had initially expected, most funds are expected to rely exclusively on third-party service providers to classify and monitor the liquidity of their portfolio securities “thereby resulting in even more complexity and raising interpretive questions.” The SEC noted that this reliance is being caused, in part, by market data gaps for certain asset classes, such as certain fixed-income securities, which may require complex classification and monitoring systems. The SEC acknowledged that many funds are continuing to conduct extensive due diligence on the service providers' systems in order to determine which classification and monitoring systems will best suit their needs.

The SEC noted that system readiness issues of funds and service providers remain and that they would need additional time to refine and test their classification and monitoring systems. In addition, the SEC noted that many industry participants had reported that they would not be able to assess the services offered by vendors until those systems were more fully developed. The SEC noted that, although vendors expected to develop effective systems by the original compliance dates, those systems were not yet complete and vendors did not yet have the ability to fully assess securities in certain asset classes—such as over-the-counter derivatives and certain fixed-income securities, including asset-backed securities, mortgage-backed securities, preferred securities, bank loans, and to-be-announced securities. The SEC also noted that different service provider systems were generating “unexpectedly disparate” liquidity classifications of certain securities, leading funds to conduct additional due diligence on the causes of these differences, causing additional delays in system rollouts. Further, the SEC observed that fund groups that engage sub-advisers were grappling with additional complexity relating to sharing and reconciling classification information.

Finally, the SEC noted that the compliance deadline extension was warranted because “many of the most difficult interpretative questions relating to the [Liquidity Rule]” are only now becoming apparent as fund groups design, evaluate and test “new and complex systems.” Without the deadline extension, the SEC stated that funds would have to incur the expense of implementing portfolio classification systems now, only to later have to make changes to reflect interpretative guidance issued by the SEC or its staff. Further, the unanticipated implementation complexity and unexpectedly extensive role that service providers are expected to play as part of funds' liquidity programs, the SEC believes, will result in still more interpretative questions that the SEC and its staff will need to address.

WHAT IS NOT DELAYED

The SEC did not delay the remaining provisions of the Liquidity Rule. In determining not to delay any other rule provisions, the SEC noted that funds should not have difficulty implementing a liquidity risk management program, because funds already have experience complying with an existing SEC-imposed 15% limit on investments in illiquid assets (albeit that the Liquidity Rule includes a somewhat different definition of what qualifies as an “illiquid investment”) [8] and compliance with the remaining provisions by the original dates is feasible. Thus, funds will need to comply with these provisions by the original compliance dates:

6. Adoption and implementation of a liquidity risk management program—even if it is not board-approved until the extended compliance date and does not contain provisions for portfolio classification and related requirements (Rule 22e-4(b) & (b)(1)(i));
7. Compliance with the 15% limit on illiquid investments (Rule 22e-4(b)(1)(iv));
8. Establishment of policies and procedures for funds that engage in, or reserve the right to engage in, redemptions in-kind (Rule 22e-4(b)(1)(v));

9. Board designation of a program administrator (Rule 22e-4(b)(2)(ii));
10. Form N-LIQUID reporting related to general liquidity information and reporting related to illiquid investments (Parts A, B & C); and;
11. Form N-CEN reporting related to lines of credit, inter-fund lending and borrowing, as well as In-Kind ETF status (Items C.20 & E.5).

GUIDANCE ON 15% ILLIQUID INVESTMENT LIMITATION FOR FUNDS NOT ENGAGING IN FULL PORTFOLIO CLASSIFICATION AND FOR IN-KIND ETFS

The adopting release for the Interim Rule also offered guidance regarding the 15% limit on investment in illiquid investments under the Liquidity Rule absent the use of full portfolio classifications. This would apply to all funds that will not engage in full portfolio classifications by the time they are required to comply with the 15% limit on investments in illiquid investments, which will now precede the compliance dates for full portfolio classifications for applicable funds and also In-Kind ETFs.

The SEC believes that one reasonable method to identify illiquid investments for purposes of the 15% limit on investments in illiquid securities is to engage in a "*preliminary evaluation*" whereby a fund develops a reasonable belief that an investment is likely to be illiquid. This belief could be supported by, among other matters, previous trading experience (including experience with market depth and trading market impact), or general characteristics of the evaluated asset class. For example, the SEC believes that a fund's policies and procedures might reasonably require additional monitoring in reviewing acquisitions as the fund's percentage of illiquid investments increases.

The SEC believes that a fund could rely solely on its preliminary evaluation and not engage in further analysis at that time, absent certain events discussed below. Investments in asset classes reasonably believed not to fall into the illiquid category would not need to be classified when performing this preliminary analysis. Alternatively, a fund may engage in a "*secondary evaluation*" where an investment's illiquidity is evaluated through the full classification process set forth in Rule 22e-4(b)(1)(ii). Additionally, the SEC stated that funds not engaging in full portfolio classification and In-Kind ETFs can adhere to the Interim Rule's guidance or use other "reasonable methods to identify and monitor their illiquid investments."

The SEC stated that funds could automate this preliminary evaluation process for asset classes and investments and base that evaluation on general characteristics of portfolio investments. For example, the SEC believes that a fund could establish a list of asset classes or investments it reasonably believes are likely illiquid based on trading characteristics (e.g., restricted security or structural liquidity limitations, asset class trading history or negotiations required to trade). The SEC expects any fund using a preliminary evaluation methodology to periodically test the accuracy of illiquidity determinations.

The SEC does not believe that market depth evaluations using a single trading lot would be reasonable. This does not mean that the fund must evaluate market depth based on the actual fund holdings or engage in the full process of evaluating its reasonably anticipated trading size. Instead, the fund could use any "reasonable method in evaluating the market depth of the asset classes or investments it identifies" preliminarily as illiquid.

The SEC guidance states that certain events may require a fund to evaluate illiquidity more frequently than upon acquisition and then monthly thereafter. A reasonable approach for re-evaluation of illiquidity, for instance, might be policies and procedures identifying in advance events that would cause a re-evaluation. Such events could be reasonably limited to those that are "objectively determinable" such as a trading halt or delisting, default or bankruptcy, significant macroeconomic developments, or developments like extraordinary natural disasters for funds with concentrated geographic exposure. Nevertheless, the SEC stated that each fund should monitor its portfolio so that it does not exceed the 15% illiquid investment limitation because of "purchase or redemption activity . . . or changes in the value of the fund's holdings," although for purposes of complying with the Liquidity Rule, the 15% illiquid investment limitation is only tested immediately after the purchase or acquisition of an illiquid investment.

Finally, the SEC stated that it and its staff will continue to monitor implementation of the Liquidity Rule requirements to determine whether further action is necessary to address questions or issues that may arise. The SEC is seeking comment from the public on a variety of issues in connection with the compliance deadline extensions. Comments are due by April 27, 2018.

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[1] *See Investment Company Liquidity Risk Management Programs; Commission Guidance for In-Kind ETFs, Investment Company Release No. IC-33010* (Feb. 22, 2018) ('Interim Rule") (www.sec.gov/rules/interim/2018/ic-33010.pdf).

[2] On the day before, the SEC's Division of Investment Management issued a second round of guidance in the form of Frequently Asked Questions, addressing compliance questions related to the Liquidity Rule. For additional information on that guidance, see our alert: *Division of Investment Management Issues Second Round of FAQs on Liquidity Risk Management Programs.*

[3] The Liquidity Rule applies to "funds" that are open-end investment companies, including exchange-traded funds ("ETFs") but excluding money market funds. The Interim Rule's deadline extension applies to funds except for In-Kind ETFs to which the delayed requirements do not apply in any event.

[4] Or more frequently in certain circumstances.

[5] On March 14, 2018, the SEC proposed amendments to certain disclosure requirements of the Liquidity Rule. For additional information on the proposed amendments, see our alert: *SEC Proposes Rule Changes to Public Liquidity Risk Management Disclosures*.

[6] "In-Kind ETF" is defined under Rule 22e-4(a)(9) 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."

[7] "'Larger 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 of the fund. 'Smaller entities' are defined as funds [with] net assets of less than $1 billion as of the end of its most recent fiscal year." Interim Rule at n. 5.

[8] "Illiquid investment" is defined under the Liquidity Rule as "any investment that the fund reasonably expects cannot be sold or disposed of in current market conditions in seven calendar days or less without the sale or disposition significantly changing the market value of the investment . . . ." In contrast to the SEC guidance that

existed prior to the Liquidity Rule, a fund is required to take into account relevant market, trading and investment-specific considerations, as well as market depth, when determining whether a portfolio holding is illiquid.

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