DIVISION OF INVESTMENT MANAGEMENT ISSUES SECOND ROUND OF FAQS ON LIQUIDITY RISK MANAGEMENT PROGRAMS

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U.S. Investment Management Alert

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On February 21, 2018, the Securities and Exchange Commission's ("SEC") Division of Investment Management (the "Division") issued additional guidance related to Rule 22e-4 under the Investment Company Act ("Liquidity Rule" or "Rule") [1] in the form of Frequently Asked Questions ("FAQs"). [2] This second round of guidance adds FAQs 16—34 (and slightly amends FAQ 13) [3] to those the Division of Investment Management issued on January 10, 2018. The new FAQs, which are discussed below, are primarily concerned with:

- Asset Class Liquidity Classification (FAQs 16–18);
- Reasonably Anticipated Trading Size (FAQs 19–21);
- Price Impact Analysis (FAQ 22);
- Classifying Investments in Pooled Investment Vehicles (FAQ 23);
- Provisional Investment Classification Activity and Related Compliance Monitoring (FAQs 24–26);
- Timing and Frequency of Classification of Investments (FAQs 27–29);
- Pre-Trade Activity and the 15% Limitation on Illiquid Investments (FAQs 30–31);
- Related Reporting Requirements (FAQs 32–33); [4] and
- Non-In-Kind-ETFs and Investment Classification (FAQ 34).

ASSET CLASS LIQUIDITY CLASSIFICATION

The Liquidity Rule permits funds to classify the liquidity of their investments into one of four prescribed categories by their asset class, but funds are required (under an "exceptions policy") to separately classify an investment if a fund or its adviser, after reasonable inquiry, obtains information regarding any market, trading, or investment-specific considerations that are reasonably expected to significantly affect the liquidity characteristics of that investment.

The FAQs state that funds relying on the asset class liquidity classification methodology are permitted to have an exceptions policy that identifies the liquidity characteristics that they reasonably expect "would make an investment a *significant* departure from the range of liquidity characteristics present within its asset class" (emphasis in original). Moreover, the FAQs indicate that, although different investments within an asset class may exhibit a range of liquidity profiles, as long as the investments continue to fall within the asset class' liquidity characteristic range, the Division would not expect them to trigger the exceptions policy's separate classification review process. Rather, only deviations in the liquidity range that would have a “significant effect” on the investments' liquidity characteristics need trigger a separate review. [5] In this regard, the FAQs state that “more sensitive exception methodologies may result in numerous false positives,” thereby undermining the flexibility offered by the asset class liquidity classification methodology.

The FAQs also indicate that funds may rely on automated processes as part of their framework to review asset class liquidity classification exceptions, which could potentially ease the Liquidity Rule's compliance burden on funds. In addition, funds relying on the asset class liquidity classification methodology must periodically test their exceptions framework, including any automated processes thereunder.

REASONABLY ANTICIPATED TRADING SIZE

The Liquidity Rule requires that funds consider, among other matters, the varying levels at which they reasonably expect to trade in a particular investment, or asset class in the case of funds relying on the asset class liquidity classification methodology (“reasonably anticipated trading sizes”), when classifying the liquidity of the investment or asset class. With respect to funds that rely on the asset class liquidity classification methodology, the FAQs state that such funds may determine the reasonably anticipated trading sizes for all of their investments within a particular asset class but should consider whether using any fixed dollar amounts is reasonable (as opposed to using percentages) “because using fixed dollar amounts on positions of widely varying size may result in unreasonable trading sizes in some cases.”

The FAQs also state that, in analyzing their reasonably anticipated trading sizes, funds are not required to consider trades executed for reasons other than meeting redemptions. [6] In addition, the FAQs state that funds should not attempt to predict their future portfolio management decisions to meet future redemptions, such as the precise identity, number, and order of the securities the funds would sell to meet redemptions. Rather, funds should estimate the portion of their investments that they reasonably believe they “could choose to sell to meet redemptions” and may make “simplifying assumptions” to determine their reasonably anticipated trading sizes. For example, the FAQs indicate that “a fund could conclude that selling all portfolio investments pro rata in response to a redemption would be a reasonable baseline assumption…and determine [its] reasonably anticipated trading sizes accordingly.” A fund could also consider other assumptions, although the FAQs warn that a zero, or near zero, reasonably anticipated trade size would be inappropriate because any illiquid security could become a highly liquid security under such a methodology.

PRICE IMPACT ANALYSIS

The Liquidity Rule requires that funds consider how quickly they can convert an investment to cash (or otherwise dispose of it) “without . . . significantly changing the market value of the investment.” The FAQs state that funds have the flexibility to determine what constitutes a “significant change” in the market value of an investment in their policies and procedures since this evaluation is subjective and may “vary by fund, asset class, or investment.” The FAQs further clarify that the determination of what represents a “significant change” in the market value of an investment need not be a fixed amount or percentage, “and a fund may have differing standards for different investments and/or asset classes, although a fund may also choose to use a fixed number if reasonably determined.”

CLASSIFYING INVESTMENTS IN POOLED INVESTMENT VEHICLES

The FAQs state that when classifying the liquidity of investments in pooled investment vehicles—including mutual funds, ETFs, closed-end funds, and private funds—a fund could base its liquidity classification on factors specific to the investment. For both redeemable and non-redeemable pools, the staff would not expect a fund to “look through” the pool's portfolio to the underlying investments unless the fund had reason to believe that the liquidity of the underlying investments would alter the fund's liquidity classification of the pooled investment vehicle. Thus, the staff would ordinarily expect the classification analysis of ETFs, for instance, to be performed as it would be for any exchange-traded security. For mutual funds and hedge funds, the staff would expect a fund to examine primarily the ordinary redemption or withdrawal rights and practices specific to that investment.

PROVISIONAL INVESTMENT CLASSIFICATION ACTIVITY AND RELATED COMPLIANCE MONITORING

The FAQs state that a fund should calculate the value of its existing investments for the purpose of (1) maintaining its stated highly liquid investment minimum (“HLIM”), and (2) complying with the 15% illiquid investment limitation in conjunction with its daily computation of net asset value. The FAQs clarify that the Division does not expect daily reclassification of assets in order to determine compliance with these limits. In this regard, a fund may use the last verified and determined asset classifications for compliance monitoring purposes. Further, the FAQs assert that changes in values and position sizes, new acquisitions and reclassifications impact compliance with the HLIM and 15% illiquid investment limitations, although the 15% illiquid investment limitation is only tested immediately after the purchase or acquisition of an illiquid investment.

The FAQs define a “provisional classification” as any liquidity classification other than those reported on Form N-PORT or verified reclassifications resulting from intra-month compliance monitoring (e.g., reclassifications resulting from a triggering event). Provisional classifications are entirely voluntary and not required. The FAQs state that the Liquidity Rule does not impede funds from employing other means of assessing liquidity risk not otherwise required by the rule.

If provisional classifications or compliance monitoring indicate non-compliance with either the HLIM or the 15% illiquid investment limitations, the Division believes that a fund should verify and determine such non-compliance exists. If such non-compliance is verified and determined, the fund is required to report such non-compliance.

TIMING AND FREQUENCY OF CLASSIFICATION OF INVESTMENTS

Although the Liquidity Rule requires at least monthly review of an investment's liquidity classification, it does not specify when a fund must classify a newly acquired asset, liquidity status notwithstanding. In this regard, the FAQs state that the Division would not object if a fund classifies new assets, or reclassifies assets in which positions have been reduced or increased, during its regularly scheduled monthly classification, except for required intra-monthly reclassifications and for limiting a fund's investments in illiquid investments.

The Liquidity Rule requires that a fund conduct an intra-month re-evaluation of an investment's liquidity classification “when a fund becomes aware of changes in relevant market, trading and investment-specific considerations that are *reasonably* expected to materially affect an existing classification of that particular investment” (emphasis added). The FAQs reiterate that this intra-month requirement does not create a de facto ongoing classification evaluation requirement. The FAQs note that the Division would not object to policies and procedures that identify events reasonably expected to materially affect an investment's classification in satisfaction of the intra-month requirement and, further, would not object if those events are limited to objectively determinable events such as a trading halt or delisting. Intra-month events causing the reclassification of an investment, the Division believes, will cause a fund to determine whether to reclassify only those investments the fund reasonably expects to be affected by the event and not its entire portfolio.

PRE-TRADE ACTIVITY AND THE 15% LIMITATION ON ILLIQUID INVESTMENTS

The FAQs clarify that a fund is not expected to classify an investment on a pre-trade basis and that a fund could classify newly acquired securities at the next monthly portfolio classification, unless the fund becomes aware of information that might require a reclassification. However, a fund still needs to have policies and procedures to meet the 15% illiquid investment limitation immediately after purchase or acquisition of an illiquid investment. The Division believes that one reasonable method to identify illiquid investments 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.

According to the FAQs, a fund could rely solely on its preliminary evaluation and not engage in further analysis at that time, absent such objectively determinable events described above. Investments in asset classes reasonably believed not to fall into the illiquid category would not need to be classified when performing this preliminary analysis. However, the Division believes that a fund's policies and procedures might reasonably require, for instance, additional monitoring in reviewing acquisitions as the fund's percentage of illiquid investments increases.

The FAQs state that funds could automate this preliminary evaluation process for asset classes and investments and base that evaluation on general characteristics of fund purchases. For example, the Division believes that a fund could establish a list of asset classes or investments it 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 Division expects that any fund using a preliminary evaluation methodology will periodically test the accuracy of illiquidity determinations.

When formulating assumptions about a security's liquidity, for purposes of preliminary evaluation or monthly classification, a fund would need to estimate the security's market depth. The Division 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, but a fund should use any "reasonable method in evaluating market depth of the asset classes or investments" it identifies preliminarily as illiquid.

RELATED REPORTING REQUIREMENTS

In addition to certain other reporting requirements, the Liquidity Rule requires that a fund notify its board and file a report with the SEC if it falls short of its HLIM for more than seven calendar days. Nevertheless, the FAQs acknowledge that in certain circumstances, funds may need a reasonable amount of time to verify and determine that a reporting event has occurred. The Division believes that, in general, this verification and determination process should be completed in three (3) business days or less, including the day the triggering event was observed.

In addition, the FAQs indicate that, under these circumstances, the reporting requirements are only triggered on the date a fund has verified and determined that a reporting event has occurred. In such reports however, a fund should include the number of days it took to make its verification and determination in reporting to the number of days it exceeded the 15% limit on illiquid investments or breached its HLIM. In addition, the FAQs suggest that funds report both the date of the triggering event and the date that the fund verified and determined non-compliance in its reporting of Form N-LIQUID to resolve any ambiguity.

NON-IN-KIND ETFS AND INVESTMENT CLASSIFICATION

Under the Liquidity Rule, ETFs that pay redemptions in-kind and with no more than a *de minimis* amount of cash are exempt from the classification and HLIM provisions of the rule. [7]

The FAQs acknowledge that an ETF that does not meet the definition of In-Kind ETF, but “redeems shares in-kind to any material extent” nevertheless has a different liquidity profile and different liquidity risks than funds that redeem in cash. The Division thus believes that such an ETF could reflect these differences in its liquidity classifications and in designating its HLIM. The FAQs do warn, however, that less liquid assets may be less likely to transfer in-kind anyhow and that using a single trading lot or a zero or near zero assumed reasonably anticipated trading size would be inappropriate. This guidance also applies to mutual funds that engage in in-kind redemptions to any material extent.

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[1] On the next day, the SEC adopted an interim rule that delays the compliance dates of certain provisions of the Liquidity Rule. For additional information on the SEC's interim rule, see our alert: *SEC Delays Certain Liquidity Rule Requirements and Issues Guidance Regarding Illiquid Security Determinations.*

[2] Investment Company Liquidity Risk Management Programs Frequently Asked Questions (www.sec.gov/investment/investment-company-liquidity-risk-management-programs-faq).

[3] FAQ 13 addresses methods by which an In-Kind ETF can test for *de minimis* use of cash in redemptions. The amended answer clarifies that “[a] fund may choose to use either its daily net or total redemptions for each day of the period of time it selects when determining whether its cash use is de minimis.”

[4] 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*.

[5] The FAQs also reiterate that no presumption of reclassification exists where a fund identifies a “potential” exception to its asset class methodology. Rather, a fund may reasonably decide that an investment does not warrant reclassification after conducting a review of the investment.

[6] The FAQs further clarified that an assumed reasonably anticipated trading size can be used as the assumed size throughout the classification process—even in cases where the fund expects to fully liquidate the position in the near term.

[7] For additional information about cash redemption practices that would be considered de minimis see our alert: *Staff Issues FAQs Regarding Liquidity Risk Management Programs*, available at http://www.klgates.com/staff-issues-faqs-regarding-liquidity-risk-management-programs-01-25-2018/.

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