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Liquidity Management Rule – Delays and Revisions

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On October 13, 2016, the Securities and Exchange Commission (the **"SEC"**) adopted Rule 22e-4 (the **"Liquidity Rule"**) under the Investment Company Act of 1940, as amended, to require each registered open-end management investment company, including exchange-traded funds but not including money market funds, to establish a liquidity risk management program. The SEC adopted the Liquidity Rule to focus funds' attention and resources on managing liquidity risk – *i.e.*, the "risk that a fund could not meet requests to redeem fund shares without significant dilution of the remaining investors' interests in the fund."[1] The key requirements of the rule include: the adoption and implementation of a written liquidity risk management program; classification (or "bucketing") of the liquidity of each portfolio investment (including derivatives); determination of a "highly liquid investment minimum"; limitation on illiquid investments; and additional requirements on boards of directors to oversee fund liquidity management.[2]

Six Month Delay

The Liquidity Rule was originally scheduled to take effect on December 1, 2018 for "larger fund groups"[3] and June 1, 2019 for "smaller fund groups." On February 21, 2018, the SEC voted unanimously to extend the deadline for compliance with certain aspects of the Liquidity Rule by six months.[4] Specifically, it delayed the much debated "bucketing" requirement, the requirement to establish a "highly liquid investment minimum," and certain board oversight of the liquidity risk management program. Funds will still be required to implement liquidity risk management programs by December 1, 2018 (for larger fund groups). However, funds need not implement the liquidity classification/"bucketing" or "highly liquid investment minimum" requirements until June 1, 2019, at the earliest, and *boards* do not need to approve liquidity risk management programs until June 1, 2019, at the earliest.[5] Other provisions of the Liquidity Rule, including the requirement to limit a fund's illiquid investments to 15% of its portfolio, will become effective on December 1, 2018 for larger fund groups and on June 1, 2019 for smaller fund groups, as originally scheduled.

The most vocal critic of the original deadline has been the Investment Company Institute (the "ICI"). The ICI had previously submitted letters to Chairman Clayton asking that the SEC take action to refine certain elements of the Liquidity Rule. On July 20, 2017, the ICI President and Chief Executive Officer, Paul Schott Stevens, requested that the SEC relax the compliance schedule for the Liquidity Rule classification and related reporting requirements, in part to provide the SEC time to consider comments on the Liquidity Rule and potentially amend it. One amendment proposed by the ICI would have allowed funds to formulate their own classification policies and procedures. Mr. Schott's letter also requested a delay in the compliance schedule for the classification provision (and related reporting requirements) by at least one year even if the SEC determined not to pursue the ICI's recommended amendments to the Liquidity Rule.

The chart below summarizes which of the Rule's requirements are subject to the extension.[6]

	Requirements Not Subject to Extension	Requirements Subject to Extension

Rule 22e-4	• Liquidity Risk Management Program
	  • Assessment, management, and periodic review of liquidity risk (§(b)(1)(i))
	  • Illiquid investments (§(b)(1)(iv))
	  • Redemptions in Kind (§(b)(1)(v))
	  • Board Designation of Program Administrator (§(b)(2)(ii))
	  • UIT Liquidity
		• Classification ("bucketing") (§(b)(1)(ii))
		• Highly liquid investment minimum (§(b)(1)(iii))
		• Board Oversight
		  • Initial approval of the liquidity risk management program (§(b)(2)(i))
		  • Annual Board Reporting (§(b)(2)(iii))

	Requirements Not Subject to Extension	Requirements Subject to Extension
N-LIQUID	• Part A. General Information • Part B. Above 15% Illiquid Investments • Part C. At or Below 15% Illiquid Investments	• Part D. Assets that are Highly Liquid Investments Below the HLIM

Proposed Rescission of Public Disclosure Requirement

On March 14, 2018, the SEC proposed amendments to Form N-PORT that would rescind the requirement of the Liquidity Rule that funds publicly disclose liquidity classification/"bucketing" information about their portfolios.[7] In lieu of public disclosure of aggregate portfolio liquidity information, the proposed amendment would require a fund to include a narrative discussion of its liquidity risk management program in the fund's annual report. The narrative is expected to include discussion of the operation and effectiveness of the liquidity risk management program during the most recently completed fiscal year. The SEC likened this disclosure to the current Form N-1A requirement that a fund disclose the principal risks of investing in the fund, including liquidity risk if applicable.

The SEC has acknowledged concerns from industry commentators. Specifically, the SEC cited "subjectivity," "lack of context," and "liquidity risk in isolation" as the main types of concerns influencing the proposed rescission:

Subjectivity - Concerns about "subjectivity" relate to the differences in classification methodologies and assumptions being used across funds. Although there is no uniform classification methodology, Form N-PORT data across funds may seem to be comparable for an investor. Additionally, currently developed methodologies are imperfect; for example, the ICI found that the size of a fund may have a disproportionate effect on a fund's liquidity results.[8] As a consequence, investors may be confused by the differences in the liquidity profiles of a large and small fund, and may incorrectly believe that small portfolios have less liquidity risk. This inconsistency in turn diminishes the usefulness of classification information and creates confusion.

Lack of Context - "Lack of context" refers to the fact that classification information will be disclosed on Form N-PORT, which does not provide the funds an opportunity to explain their classification methodologies and assumptions. Funds cannot tailor the Form N-PORT disclosure to fund-specific risks or attempt to clarify the liquidity disclosures. Further, the liquidity classification information would be presented to the public on a 60-day delay. The staleness of the information could exacerbate the inappropriateness and misleading nature of the classification information should an investor use this information for investment decisions.

Liquidity Risk in Isolation - Finally, the "liquidity risk in isolation" concern refers to the emphasis on liquidity risk in Form N-PORT. This emphasis could encourage investors to put more weight on liquidity risk as opposed to other considerations that are more important to their individual investment objectives.

[1] *Investment Company Liquidity Risk Management Programs*, SEC Release Investment Company Act Release No. 32315 (Oct. 13, 2016) (the "Adopting Release").

[2] Also on October 31, 2016, the SEC adopted rules to modernize reporting for funds. It decided to phase out current reports N-Q and N-SAR, adopt new forms N-PORT and N-CEN, and adopt amendments to forms N-1A, N-3, and N-CSR. *Investment Company Reporting Modernization*, SEC Release Investment Company Act Release No. 32314 (Oct. 13, 2016).

[3] Larger fund groups are those with net assets greater than $1 billion. *See,* Adopting Release.

[4] *SEC Votes to Modify Compliance Date for Open-End Fund Liquidity Classification*, SEC Release 2018-24 (Feb. 21, 2018), available at: https://www.sec.gov/news/press-release/2018-24.

[5] *Investment Company Liquidity Risk Management Programs; Commission Guidance for In-Kind ETFs,* SEC Release No. IC-33010 (Feb. 22, 2018), available at: https://www.sec.gov/rules/interim/2018/ic-33010.pdf.

[6] *Id.* (lightly edited and reformatted).

[7] *Investment Company Liquidity Disclosure*, SEC Release Investment Company Act Release No. 33046 (Mar. 14, 2018), available at: https://www.sec.gov/rules/proposed/2018/ic-33046.pdf.

[8] Letter from Investment Company Institute (Nov. 3, 2017), available at: https://www.sec.gov/comments/s7-16-15/s71615-2674225-161457.pdf