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Client Alert

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SEC Adopts Liquidity Management Rules

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On October 13, 2016, the Securities and Exchange Commission (the "SEC") adopted the final rule requiring open-end investment companies to establish liquidity risk management programs.

The SEC's adopting release[1] discusses its view that significant growth in open-end funds' assets and increasing use of fixed income and less liquid, alternative strategies have led to heightened liquidity risk and that if liquidity is poorly managed, funds might not be able to meet redemption requests without diluting the interests of remaining shareholders.

The adopting release indicates that the primary goals of the final liquidity regulations are: to promote investor protection by reducing the risk that funds will be unable to meet their redemption obligations; elevate the overall quality of liquidity risk management across the fund industry; increase transparency of funds' liquidity risks and risk management practices; and mitigate potential dilution of non-transacting shareholders' interests.

The new fund liquidity risk management program rule and related rule amendments (together, the "liquidity risk management program rule" or "rule") were adopted on the same date as other new rules relating to swing pricing and reporting modernization (discussed in separate client alerts). These new rules are part of a broader and sweeping regulatory initiative by the SEC that includes: (i) the proposed rule relating to derivatives published in December 2015; (ii) a new proposed rule requiring business continuity plans for investment advisers and published guidance for fund business continuity plans released earlier this year; and (iii) annual stress testing requirements for certain funds and investment advisers, which the SEC has indicated are also in development.

What are the Basic Requirements of Fund Liquidity Risk Management Programs?

Under the liquidity risk management programs required by the new rule, funds must:

- assess, manage and periodically review their liquidity risk;
- classify their assets into four buckets by their level of liquidity;
- set minimum percentages of their portfolios that must be invested in highly liquid assets; and
- limit illiquid investments to 15% of their portfolios.

In addition to the above, new and amended rules and forms adopted by the SEC also impose additional reporting and disclosure requirements.

What Funds are Subject to the New Rule?

The liquidity risk management program rule, codified under new Rule 22e-4 under the Investment Company Act of 1940 (the "1940 Act"), generally applies to all open-end management investment companies, except for registered open-end management investment companies that are regulated as money market funds under Rule 2a-7 of the 1940 Act. The rule is also applicable to open-end exchange-traded funds ("ETFs"), subject to certain exceptions and special provisions discussed below, including certain specific exceptions with respect to ETFs that redeem all but a *de minimis* amount of their shares in kind and disclose their portfolio holdings daily ("In-Kind ETFs"). Closed-end funds are not subject to the new rule. Unit investment trusts ("UITs") are excluded from the rule's liquidity risk management program requirements but are required to perform a limited liquidity review under the rule.

What is the Compliance Date for the New Rule?

Larger entities (funds that, together with other funds in the same "group of related investment companies" have net assets of more than $1 billion as of the end of the most recent fiscal year) must comply with Rule 22e-4 **by December 1, 2018**. Smaller fund complexes with less than $1 billion in assets must be in compliance **by June 1, 2019**.

Requirements of Liquidity Risk Management Programs

The new rule requires that funds adopt and implement a written liquidity risk management program. The program must be reasonably designed to assess and manage the fund's liquidity risk. "Liquidity risk" is defined as the risk that a fund could not meet redemption requests without significantly diluting the remaining shareholders' interests. The program must include policies and procedures reasonably designed to incorporate the following elements:

1 Investment Company Liquidity Risk Management Programs, Investment Company Act Release No. 32315 (Oct. 13, 2016) (the "adopting release").

> Assessment, Management and Periodic Review of Liquidity Risk

Pursuant to the rule, funds must consider the factors listed below, as applicable, in assessing liquidity risk:

- 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;

- Short-term and long-term cash flow projections during both normal and reasonably foreseeable stressed conditions; and
- Holdings of cash and cash equivalents, as well as borrowing arrangements and other funding sources.

The final version of the rule streamlines the liquidity factors as originally set out in the proposed rule.[2] However, the SEC added new requirements that funds must consider: (i) whether funds' strategies are appropriate for an open-end structure and (ii) the extent to which strategies involve relatively concentrated portfolios or large positions in certain issuers. The adopting release notes that these two factors are particularly significant in weighing liquidity risk. It also points out that the factors above do not represent an exhaustive list, and recommends that funds consider additional factors as necessary to manage liquidity risk.

Cash Flow Guidance. With respect to the analysis of short-term and long-term cash flow projections during both normal and reasonably foreseeable stressed conditions, the adopting release states that funds should take into account cash flow guidance included in the adopting release. The guidance suggests that funds should analyze, among other factors: (i) the size, frequency and volatility of the fund's historical purchases and redemptions; (ii) ownership concentration; and (iii) distribution channels.

Review Requirements. The rule provides that funds must review liquidity risk no less than annually, but the adopting release notes that it may be appropriate for some funds to review liquidity risk more frequently.

Additional Considerations for ETFs (including In-Kind ETFs). In addition to the four factors listed above, ETFs must also consider:

- 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; and
- The effect of the composition of baskets on the overall liquidity of the ETF's portfolio.

> Classification of Portfolio Investments

Each fund must, using information obtained after reasonable inquiry and taking into account relevant market, trading, and investment-specific considerations, classify each of the fund's portfolio investments (including each of the fund's derivative transactions) into one of four categories: (1) highly liquid; (2) moderately liquid; (3) less liquid; and (4) illiquid. The proposed rule would have required that funds classify each of their investments into one of six categories based on the investment's liquidity.

Measuring Liquidity. For purposes of these classifications and Rule 22e-4 generally, liquidity is measured by the number of days the fund expects that it would take to convert the investment to cash (defined under the rule as sold, with the sale settled) or otherwise sell or dispose of it in current market conditions without significantly changing its market value. This determination must take into account relevant market, trading and investment-specific considerations, as well as the investment's market depth (*i.e.*, whether smaller portions of a position are more liquid than larger portions). Under the rule, the fund must determine whether trading varying portions of a particular portfolio or investment class, in sizes that the fund would reasonably anticipate trading, would significantly affect its liquidity, and if so, the fund must take this determination into account when classifying that investment or asset class. The rule also specifically references the adopting release for a discussion of considerations that may be relevant in classifying the liquidity of a fund's investments. These nine factors were originally enumerated as specific factors in the proposed rule.

Liquidity Buckets

Liquidity Category	Can be converted to cash (*i.e.*, sold, with the sale settled) in:	Can be sold or disposed of in:
Highly liquid	3 business days or less	
Moderately liquid	Between 4 and 7 calendar days	
Less liquid		7 or fewer calendar days, but settlement is reasonably expected to take more than 7 calendar days
Illiquid		More than 7 calendar days

2 Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release, Investment Company Act Release No. 31835 (Sept. 22, 2015).

Current Market Conditions. In a change from the proposed rule, the final rule requires that liquidity determinations be based upon current market conditions. The SEC notes in the adopting release that liquidity classification data would thus be more useful as it would reflect funds' assessments in light of actual, not anticipated, markets and would help the SEC staff to understand how the same set of market conditions could disparately impact different funds' assessments of their liquidity and that of different asset classes. However, reasonably foreseeable stressed conditions are still required to be considered as part of the liquidity risk assessment and management requirements.

Classifying Holdings by Asset Class. The adopting release notes that an asset class may include many investments that are interchangeable from a liquidity perspective. To reduce the operational burdens of classifying each individual portfolio asset, the final rule permits funds to classify holdings by asset class rather than per each individual investment, provided the fund separately classifies and reviews any investment within an asset class if the fund or its adviser has information about any market, trading, or investment-specific considerations that are reasonably expected to significantly affect the liquidity characteristics of that investment as compared to the fund's other portfolio holdings within that asset class. The adopting release provides that reasonably designed policies and procedures would likely specify the information that the fund would consider in making such an exception. This information might include whether, relative to its asset class, the investment's market is exceptional in terms of size, breadth or depth or if its typical bid-ask spreads were generally wider, narrower or more volatile compared to other investments in the same asset class. The final rule also indicates that if an investment could fall within either the highly liquid or moderately liquid categories because the period to convert the investment to cash depends upon the calendar or business day convention used (*e.g.*, if a fund might settle in three business days but potentially there could be weekend days in between making it between four and seven calendar days), then the highly liquid classification should be used for that investment.

Treatment of Derivatives. The rule requires a fund, for derivative transactions that are classified as moderately liquid, less liquid or illiquid, to identify the percentage of the fund's highly liquid investments that it has segregated to cover, or pledged to satisfy margin requirements in connection with derivatives transactions in each of these classification categories. The rule does not require reporting on any highly liquid assets segregated in connection with derivatives that are themselves highly liquid.

Review Requirements. The proposed rule required "ongoing review" of these classifications, but the final rule imposes a more specific requirement. The rule provides that funds must review these classifications at least monthly in connection with their obligation to report these classifications on new Form N-Port, as well as more frequently if market, trading and investment-specific considerations warrant.

Exception for In-Kind ETFs. The rule exempts In-Kind ETFs from the requirement to classify the liquidity of portfolio investments. In-Kind ETFs are defined under the rule as ETFs that meet redemptions through in-kind transfers of securities, positions, and assets other than a *de minimis* amount of cash and that publish their portfolio holdings daily.

> Determination of a Highly Liquid Investment Minimum

The rule requires funds to set a "highly liquid investment minimum" or a minimum percentage of their portfolios that must be invested in highly liquid assets. Highly liquid investments are cash, or investments that are reasonably expected to be covertible to cash within three business days without significantly changing the market value of the investment.

In determining the highly liquid investment minimum, funds must consider the liquidity risk factors as set forth in the rule and discussed above. However, in a change from the rule proposal, the rule specifies that the factors relating to (i) investment strategy and liquidity of portfolio investments during both normal and reasonably foreseeable stressed conditions and (ii) short-term and long-term cash flow projections during both normal and reasonably foreseeable stressed conditions should only be considered as they apply during normal conditions, and during stressed conditions only to the extent that they are reasonably foreseeable during the period until the next review of the highly liquid investment minimum.

The adopting release also notes that while the highly liquid investment minimum is an important liquidity risk management tool, it is not meant to suggest that a fund should use only, or primarily, highly liquid investments to meet redemptions.

Shortfall Policies and Procedures. Under the proposed rule, a fund could not invest in less liquid assets if it fell below the minimum liquidity threshold (the "acquisition limit"). In the adopting release, the SEC noted that the acquisition limit could cause funds to deviate from their investment strategies and lead to increased redemptions. As a result, the final rule replaces the proposed acquisition limit with a requirement that funds adopt "shortfall policies and procedures." Shortfall policies and procedures should detail funds' actions when their investments in highly liquid assets fall below the highly liquid investment minimum. Under these policies and procedures, funds must report any shortfalls to the board at the next regularly scheduled board meeting or sooner. Management must also include a discussion of the minimum in the annual reports to the board on the liquidity risk management program. If highly liquid investments fall below the minimum for more than seven consecutive calendar days, the fund must report the situation to its board within one business day and submit a non-public, confidential report to the SEC.

Annual Review. Funds must review the highly liquid investment minimum no less frequently than annually.

Exceptions. The highly liquid investment minimum requirement does not apply to funds that primarily hold highly liquid investments (such as a highly liquid index fund) or In-Kind ETFs. The adopting release notes that the SEC would be unlikely to consider a fund with less than 50% of its assets in highly liquid investments as "primarily" holding highly liquid investments. For purposes of this calculation, the adopting release provides that funds may not include highly liquid investments segregated to cover derivatives transactions that would not be considered highly liquid investments themselves.

> 15% Illiquid Investments Limit

The rule prohibits funds from acquiring any illiquid investment if the acquisition would cause the fund's illiquid investments to exceed 15% of net assets.[3] This is a codification of longstanding SEC guidelines that generally limit an open-end fund's aggregate investments in illiquid assets to no more than 15% of a fund's net assets. In an added requirement, the final rule provides that if a fund exceeds the 15% limit, the breach must be reported confidentially to the SEC and also to the board within one business day. This report to the board must include a plan to bring the fund back into compliance within a reasonable amount of time. If the situation persists for more than 30 days (and at each 30-day period thereafter), the board must consider whether the plan presented to it continues to be in the fund's best interests. The SEC suggested in the adopting release that if it appears that a fund will not be able to restore compliance with the 15% limit in a time period consistent with its redemption obligations, the fund should consider whether its strategy is appropriate for an open-end investment fund.

Board Oversight

Required Board Approvals. The rule provides that fund boards are responsible for oversight of funds' liquidity risk management programs. The final rule eliminates some of the proposed rule's more specific board approval requirements such as with respect to the highly liquid investment minimum. Under the final rule fund boards, a majority of independent directors must:

- Initially approve funds' liquidity risk management programs;
- Approve the designation of the person(s) designated to administer the program; and
- Review, no less frequently than annually, a written report prepared by the person(s) designated to administer the program that addresses: (i) the operation of the program and assesses the adequacy and effectiveness of implementation including, if applicable, the operation of the highly liquid investment minimum and (ii) any material changes to the program.

General Oversight, Not Management. The SEC indicates in the adopting release that it expects directors to exercise their reasonable business judgment in overseeing the program on behalf of a fund's investors. The SEC emphasized that the board's role with respect to fund liquidity risk management is one of general oversight consistent with the board's role and responsibilities in other contexts under the 1940 Act (*e.g.*, Rule 38a-1 compliance programs).

- ☑ Use of program summaries. For example, similar to fund compliance programs, the adopting release provides that directors may meet their obligations regarding initial approval of the liquidity risk management program by reviewing summaries that describe the program's key features and how the program addresses the liquidity risk assessment requirements under the rule.

- ☑ Annual written report. Similar to Rule 38a-1, the board will be required to review, no less than annually, a written report prepared by the investment adviser, officer or officers designated to administer the liquidity risk management program that describes the adequacy and effectiveness of the program, including the highly liquid investment minimum, and any material changes to the program. Under the proposed rule, boards were required to approve any material changes to the liquidity risk management program. The final rule eliminates that requirement and brings the rule more in line with that of Rule 38a-1 and the board's obligations in connection with the annual written fund compliance program report.

Approval of Designation of the Administrator of the Program. The board is responsible for the designation of the fund's investment adviser, officer, or officers responsible for administering the fund's liquidity risk management program. Responsibility for administering the program cannot be designated solely to the fund's portfolio managers. However, the adopting release notes that the program administrator may wish to consult with the fund's portfolio managers, traders, risk managers, and others, as necessary or appropriate. Portfolio managers may be part of any committee or group designated to administer the program. The adopting release states the SEC view that portfolio managers should provide day-to-day management of funds, with an additional layer of oversight provided by the risk and compliance framework, and that requiring the officer or officers responsible for administering the fund's liquidity risk management program not be solely portfolio managers strikes the appropriate balance between independence and expertise.

The SEC notes that while service providers might assist a fund and its investment adviser by providing information relevant to assessing and managing liquidity risk, the primary parties responsible for a fund's liquidity risk are the fund itself and any parties to whom the fund has delegated responsibility for administering the program. The adopting release indicates certain examples of when a fund's service providers could assist a fund and its investment adviser in monitoring the factors relevant to liquidity risk, including that third parties could provide data relevant to assessing fund flows and that a sub-adviser necessarily would be responsible for investing a fund's assets in accordance with the fund's highly liquid asset minimum. The final rule requires a fund to oversee any liquidity risk

3 For purposes of calculating the percentage of illiquid investments and the percentage of highly liquid investments, the release clarifies that funds should only consider investments with positive values..

monitoring or risk management activities undertaken by the fund's service providers.

Monitoring of Highly Liquid Investment Minimum. Under the final rule, the board of a fund is not required to approve funds' highly liquid investment minimums. Instead, the annual written report submitted to the board must discuss the adequacy of the highly liquid minimum and the effectiveness of its implementation. The board, including a majority of independent directors, would be required, however, to approve any proposed change to such minimum where a fund seeks a change while the fund is below the pre-established minimum.

Boards are required to be notified by their next regularly scheduled board meeting of any occasion when a fund drops below its highly liquid minimum. This board notice must include an explanation of what caused the shortfall, the extent of the shortfall and actions taken in response. If a fund remains below its highly liquid investment minimum for more than seven consecutive calendar days, the board must be notified within one business day. The report to the board must include an explanation of how the fund plans to restore compliance with the minimum in a reasonable amount of time. The adopting release notes that these board reporting requirements are designed to foster discussion between fund boards and management and assist fund boards in their oversight of liquidity risk.

Board Oversight of 15% Illiquidity Limit. A board must be informed within one business day if a fund's holdings of illiquid assets exceed 15% of its net assets. The board must receive an explanation of the extent and causes of the occurrence and how the fund plans to bring illiquid assets back within the 15% limit within a reasonable period of time. If a fund remains out of compliance with the 15% limit for more than 30 consecutive calendar days, the board, including a majority of independent directors, must assess whether the remediation plan previously presented to the board continues to be in the best interests of the fund.

Board Reports. Fund boards must review at least annually a written report regarding the operation, adequacy and effectiveness of the program and any material changes. As noted above, a fund board must also receive reports if the fund breaches the highly liquid asset minimum or the 15% illiquid asset limit.

> Redemptions in Kind Policies and Procedures

The rule requires that, as part of the management of its liquidity risk, a fund that engages in, or reserves the right to engage in, in-kind redemptions (and any In-Kind ETF) adopt and implement written policies and procedures regarding how and when it will engage in such redemptions in-kind. The adopting release states that well-designed policies and procedures would likely address the particular circumstances in which a fund might employ in-kind redemptions, for example, detailing 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 and whether a fund would use in-kind redemption for all requests or only for requests over a certain size. The adopting release also suggests that a fund may consider having different procedures for different shareholder types and that effective policies and procedures would also likely address how a fund would determine which securities to use for in-kind redemptions (*e.g.*, would it use illiquid or restricted securities) or whether it plans to redeem in kind in a pro rata manner.

> Recordkeeping Requirements

Recordkeeping. With respect to recordkeeping, funds must maintain: (i) written copies of the liquidity risk managment programs and any policies and procedures adopted in connection with their programs that are in effect, or that were in effect at any time within the past five years, in an easily accessible place; (ii) copies of any materials provided to the board in connection with the initial approval of the liquidity risk management program and the annual written report to the board regarding the program, for a period of at least five years after the end of the fiscal year in which the documents were provided, the first two years in an easily accessible place; and (iii) if applicable, written records of the policies and procedures relating to how the highly liquid investment minimum and any adjustments thereto were determined, including assessment of the factors considered, as well as any materials provided to the board in connection with reports on shortfall policies and procedures for a period of not less than five years (the first two in an easily accessible place) following the determination of, and each change to, the highly liquid investment minimum.

Guidance on Cross Trades

Although the new rule does not contain provisions in this regard, the adopting release also provides guidance on cross-trades. The adopting release indicates that under Rule 38a-1, a fund's compliance policies and procedures related to Rule 17a-7 should contemplate how the fund meets the rule's requirements with regard to less liquid assets. The SEC then discusses a number of factors that a fund should consider including in its Rule 17a-7 procedures. The release also notes that a fund's policies and procedures might also provide for the assessment of the quality of quotations provided by dealers. In a footnote to the release, the SEC also reiterates that "evaluated prices provided by pricing services are not, by themselves, readily available market quotations."

New Reporting Requirements

Form N-PORT and Form N-LIQUID. Funds must report monthly on a confidential basis using Form N-PORT: (i) the liquidity classifications of each of their portfolio positions; (ii) their highly liquid investment minimums and the number of days the fund fell below the minimum; and (iii) the percentage of their highly liquid assets segregated to cover derivatives transactions in other liquidity categories. Funds must publicly report, on a quarterly basis, with a 60-day delay: (i) the aggregate percentage of their investments that fall into each liquidity category and (ii) the percentage of their highly liquid assets segregated to cover derivatives transactions in other liquidity categories. Additionally, a fund must notify the SEC using new Form N-LIQUID if its percentage of highly liquid assets falls below its set minimum for more than seven consecutive calendar days or if illiquid investments exceed 15% of the fund's net assets.

Other New Reporting Requirements, Including With Respect to Lines of Credit. The SEC has also adopted changes to other reporting requirements. New Form N-CEN requires that funds provide disclosure regarding their use of committed and uncommitted lines of credit and interfund borrowing and lending and ETFs must report whether they qualify as In-Kind ETFs. Amendments to Form N-1A also require more detailed descriptions of redemption practices, including a description of the methods the fund typically expects to use to meet redemption requests in stressed and non-stressed market conditions. These new disclosure requirements will apply to all open-end investment companies, including money market funds and ETFs. Funds will not be required to file credit agreements as exhibits to registration statements as originally proposed.

Summary of Certain Key Changes Made in the Final Rule

Topic	Proposed Rule	Final Rule
Defintion of Liquidity Risk		
Applicable standard	Whether the fund can meet redemption requests without materially affecting the fund's net asset value.	Whether a fund can meet redemption requests without significant dilution of remaining investors' interests.
Reference to redemptions under different types of conditions	References to redemption requests under normal conditions or reasonably foreseeable stressed conditions.	Refers generally to "requests for redemptions." Market conditions reflected in specific risk factors.
Investment Liquidity Classification		
Liquidity factors	Specifically enumerated in rule as factors to consider: • Existence of an active market for the asset, including whether the asset is listed on an exchange, as well as the number, diversity, and quality of market participants; • Frequency of trades or quotes for the asset and average daily trading volume of the asset (regardless of whether the asset is a security traded on an exchange); • Volatility of trading prices for the asset; • Bid-ask spreads for the asset; • Whether the asset has a relatively standardized and simple structure; • For fixed income securities, maturity and date of issue; • Restrictions on trading of the asset and limitations on transfer of the asset; • The size of the fund's position in the asset relative to the asset's average daily trading volume and, as applicable, the number of units of the asset outstanding; and • Relationship of the asset to another portfolio asset.	Specifically cites the adopting release for a discussion of considerations that may be relevant in classifying the liquidity of a fund's investments, which includes the nine factors that were listed in the proposed rule.
Number of liquidity classifications	Six.	Four.
Reviewing portfolio assets' liquidity on an asset-class basis	Not permitted.	Permitted, with customized exceptions for individual positions where necessary.
Frequency of review of liquidity classifications	"Ongoing review."	At least monthly, and more frequently if conditions warrant.

Topic	Proposed Rule	Final Rule
Highly Liquid Investment Minimum		
Limit on purchasing less liquid assets if minimum is not met	Yes.	No, but final rule adds requirement that funds must adopt policies and procedures to address shortfall. Requires that a fund report to its board if it goes below the minimum and requires reporting to the SEC if the shortfall lasts more than 7 consecutive days.
15% Illiquidity Limitation		
Board notice if 15% limit exceeded	Not required.	Board must receive notice within one business day after 15% limit is exceeded.
Standard for determining liquidity		Integrates the definition of illiquid investments subject to the 15% illiquid limitation as part of the portfolio classification process, requiring consideration of market, trading and investment-specific factors and market depth in determining whether illiquid and monthly review of same.
Board Approvals		
Board approval of material changes to liquidity risk management program	Required.	Not required (but such changes must be described in the annual liquidity risk management program report provided to the board).
Board approval of highly liquid investment minimum	Required.	Not required, except that board must approve any change sought while fund is below the minimum.
ETFs		
Factors to be considered in liquidity risk assessment	The factors to be considered are the same for ETFs and other open-end funds.	ETFs must weigh additional, ETF-specific factors, as described above.
Applicability of liquidity management rules	Liquidity risk management requirements apply to all ETFs equally.	In-Kind ETFs exempted from the asset classification and highly liquid investment minimum.

Practice Tips and Observations

The new fund liquidity risk management rule is arguably the most significant regulation to be adopted by the SEC since the Rule 38a-1 compliance program rule in terms of the magnitude of anticipated impact on fund operations and on board and management responsibilities. Virtually all types of funds and their operations will be affected in some way. The mutual fund industry is still in the process of evaluating the impact of the final rule as adopted on funds and their boards and on investment advisers and fund service providers, including with respect to new policies and procedures, disclosure, reporting and operational changes that will be required.

With the compliance date for the new rule set for December 1, 2018 for larger fund complexes (and June 1, 2019 for smaller fund complexes), fund groups should begin to familiarize themselves with the requirements of the rule and to consider an action plan for evaluating the impact of the rule on fund operations and the steps needed to be taken in order to comply with the rule.

- Careful review of the adopting release is important. The adopting release includes much guidance from the SEC that indirectly supplements the provisions of the rule. The final rule for the liquidity risk management program appears on its face to be more streamlined than initially proposed in terms of the specific factors required to be considered in connection with funds' liquidity programs. However, many of these same factors are now included in the adopting release and cited as guidance for complying with the assessment and review required by the rule. For example, the rule specifically references the adopting release for a discussion of considerations that may be relevant in classifying the liquidity of a fund's portfolio investments.
    - The guidance in the adopting release also provides a tool and roadmap toward the development of various new policies and procedures that will be required by the rule.
    - The adopting release also contains guidance with respect to affiliated cross-trade procedures and compliance with Rule 38a-1. The SEC states that under Rule 38a-1, a fund's Section 17a-7 policies and procedures should contemplate how the fund meets the rule's requirements with respect to less liquid assets. The adopting release provides a detailed discussion of points that the SEC staff would expect to see addressed in such policies and procedures in order for them to be considered to be reasonably designed under Rule 38a-1. Fund groups may want to review their current Section 17a-7 procedures in light of this guidance.

- The SEC noted that a board's role is one of oversight—similar to the board's role with respect to a Rule 38a-1 compliance program. Boards might want to request educational sessions to help familiarize themselves with the rule and their oversight duties and responsibilities under the same and to begin to engage in dialogues with management as to their proposed timeline for complying with the rule.

- Among other questions, funds groups may want to begin to consider who the appropriate person(s) to manage the liquidity risk management program will be. Similarly, the role of other service providers should be considered. For example, boards that oversee manager of manager structures or funds that utilize investment sub-advisers might wish to discuss the proposed role of sub-advisers under the new program. Smaller fund groups may want to consider the rule's prohibition on portfolio managers serving as the sole liquidity plan administrator. Another factor that fund groups will need to consider is with respect to who will be assisting with liquidity determinations. Will third-party service providers be utilized?

- The SEC in the adopting release states that certain funds may find themselves to be out of compliance with the provisions of the new rule after analyzing their liquidity under the factors contained in the rule and the related guidance. The SEC suggests that such funds should consider whether their strategies are appropriate for open-end management investment companies.

  The release also advises that funds with leveraged strategies and funds with greater volatility of flows such as alternative funds and emerging market debt funds may need to maintain a greater level of highly liquid assets than other funds, potentially impacting their investment strategies.

- The SEC cautions funds with strategies involving relatively less liquid securities (such as micro-cap equity funds, high yield bond funds and bank loan funds) that invest a portion of their assets in ETFs with strategies similar to the funds' investment strategies as a way to enhance liquidity to consider the extent to which relying substantially on ETFs to manage liquidity risk is appropriate. The SEC "encourages" funds to assess the liquidity characteristics of an ETF's underlying securities, as well as the characteristics of the ETF shares themselves, in classifying the liquidity of ETF shares under the rule.

- The new rule introduces some uniformity with respect to the factors to be considered under the liquidity risk assessment provisions and the 15% limitation on illiquid investments. The SEC noted in the release that currently compliance individuals and portfolio management may employ different analyses for identifying illiquid securities, and the rule is meant to harmonize this analysis.

Should you have any questions about this Alert, please feel free to call or email the authors or your contact within the Investment Management Group.

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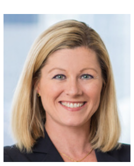

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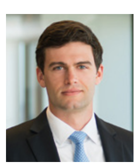

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