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SEC Announces Delay of Liquidity Risk Management Rules and Releases Additional Guidance for Funds

By Nancy P. O'Hara and Thomas J. Keefe

In a press release dated February 21, 2018, the Securities and Exchange Commission (SEC) announced that it would postpone the compliance dates for certain provisions of its liquidity risk management rules ("Liquidity Rules") by six months. According to the release, larger funds will now have until June 1, 2019, to meet the asset classification requirements of the Liquidity Rules, while smaller funds will have until December 1, 2019.¹ Importantly, the SEC has **not** postponed other provisions of the Liquidity Rules, and registered funds must still adopt liquidity risk management programs and limit illiquid investments to 15 percent of their portfolio holdings by December 1, 2018, for larger funds and June 1, 2019, for smaller funds.

In addition to announcing the modified compliance dates, the SEC's staff also released a new set of answers to frequently asked questions (FAQs) concerning the Liquidity Rules. These FAQs supplement a similar list released earlier this year² and, importantly, describe how funds should classify the liquidity of their investments in other registered funds, and clarify when funds must re-evaluate the liquidity classification of their investments. These and other clarifications are summarized below.

Summary of Key Points from the SEC's Updated FAQs on the Liquidity Rules

Asset Class Liquidity Classification

The Liquidity Rules permit funds to classify the liquidity of their investments based on asset classes, but require funds to separately classify and review any investment *reasonably expected* to depart *significantly* from the range of liquidity characteristics of its asset class. To monitor and determine whether an investment warrants separate review, funds must implement reasonable detection processes and test those processes periodically. The staff

also clarified that if a fund identifies a potential exception when using the asset class identification method, there is no presumption that the fund must reclassify that investment.

Market Depth Considerations and Reasonably Anticipated Trading Size

The Liquidity Rules require funds to consider the size of the position in an investment that they reasonably anticipate trading and the investment's market depth (i.e., whether smaller positions are more liquid than larger positions) when determining liquidity classifications. Funds may make reasonable assumptions about their anticipated trading size and market depth of investments, and may use those assumptions throughout the classification process. Additionally, if funds make liquidity classifications based on asset classes, they may set a single reasonably anticipated trading size for all assets within a particular asset class.

Price Impact Standard

Although the Liquidity Rules require funds to consider how quickly they could convert an investment into cash without changing its market value significantly, funds may determine what constitutes a significant change in market value flexibly, and employ different standards for different investments and/or asset classes.

Classifying Investments in Pooled Investment Vehicles

Where a fund invests in other pooled investment vehicles, it should generally evaluate the liquidity of the pool's shares, not the liquidity of the underlying assets. In the case of pool shares that trade on exchanges (e.g., exchange-traded fund shares), a fund should generally evaluate the pool's liquidity in a manner similar to other exchange-traded assets (e.g., common stock) and "look through" to the underlying assets only when it has reason to believe that doing so could materially alter its liquidity assessment. In the case of pools that offer redeemable securities or withdrawal rights (e.g., mutual funds), a fund should generally focus on the pool's ordinary redemption rights and practices and "look through" only when the fund has reason to believe that the pool may not be able to honor these rights and meet redemptions in accordance with its consistent practice.

¹ Under the Liquidity Rules, larger funds are those funds that, together with other funds in the same fund complex, have net assets of more than \$1 billion as of the end of the most recent fiscal year. Smaller funds are those that, together with other funds in the same complex, have net assets of less than \$1 billion as of the end of the most recent fiscal year.

² To learn more about the SEC's first set of FAQs on the Liquidity Rules, read our client alert "[SEC Releases Fund Liquidity Risk Management Programs Frequently Asked Questions](#)."

Timing and Frequency of Classification

In order to comply with the Liquidity Rules, funds should calculate what *proportion* of their existing investments are classified as illiquid when they calculate net asset value each day, but do not need to reclassify the liquidity of existing assets daily. When a fund acquires a new investment or considers an existing investment for reclassification, it may generally classify (or reclassify) the investment during the next regularly scheduled monthly classification. If, however, a fund becomes aware of changes that are reasonably expected to materially affect the existing classification of a particular investment, the Liquidity Rules require a fund to classify (or reclassify) that investment mid-month. Funds may fulfill their intra-month liquidity monitoring obligations by identifying in their policies and procedures certain events that are reasonably expected to materially alter the liquidity classification of an investment. Importantly, such events may be limited to only *objectively determinable* events, like trading halts, issuer defaults, significant macro-economic developments or, for funds with concentrated geographic exposure, extraordinary natural disasters or political upheavals.

Provisional Classifications of Investments

The FAQs refer to any liquidity classification that a fund does not report on Form N-PORT or make pursuant to a mandatory intra-month classification as a "Provisional Classification." The Liquidity Rules do not require funds to make Provisional Classifications, and funds have broad discretion in determining whether to incorporate Provisional Classifications into their liquidity risk management programs.

Pre-trade Assessments and the 15 Percent Limitation on Illiquid Assets

Although funds are not required to classify the liquidity of *prospective* investments, the Liquidity Rules require funds to implement policies and procedures that are reasonably designed to prevent trades that would cause a fund's portfolio to exceed the 15 percent illiquid investment threshold. The updated FAQs describe various procedures that funds may employ to comply with this requirement.

Reporting Requirements

When a fund exceeds the 15 percent limitation on illiquid investments or falls below its highly liquid investment minimum (if applicable), it must generally report the event to its board and the SEC on Form N-LIQUID. When such a reportable event occurs, a fund must report the violation to the SEC within three business days of the event, including the day that the triggering event occurred.

In-Kind Redemptions

Where funds make a large portion of their redemptions in kind, they may take in-kind redemption activity into account when determining the appropriate reasonably anticipated trading size and market depth for an investment.

Practice Points

Based on the updated FAQs, funds, advisers and sub-advisers should consider supplementing their written policies and procedures relating to funds' liquidity risk management programs. In particular, funds that invest in other pooled investment vehicles should consider establishing guidelines for determining when they will "look through" to the underlying assets of a pooled investment while classifying liquidity. Additionally, funds should consider establishing a list of objective criteria that will dictate whether the liquidity of an investment must be re-classified mid-month. Particularly for open-end funds that hold a large percentage of their portfolio assets in illiquid investments, funds should adopt written guidelines ensuring that Form N-LIQUID is filed with the SEC within three business days of a fund exceeding the 15 percent limitation on illiquid investments.

More SEC Guidance to Follow?

In addition to announcing that it would delay portions of the Liquidity Rules and releasing the FAQs, the SEC stated on February 21, 2018, that it anticipates considering amendments to Form N-PORT and Form N-1A. These amendments would modify liquidity disclosure requirements for open-end investment companies and might require funds to re-examine their liquidity risk management programs. As the compliance dates for the Liquidity Rules approach, expect the SEC to provide additional (and much needed) guidance to open-end funds.

Investment Management Group

Primary Contacts



Nancy P. O'Hara
Counsel
Philadelphia
(215) 988-2699
nancy.ohara@dbr.com



Thomas J. Keefe
Associate
Philadelphia
(215) 988-2641
thomas.keefe@dbr.com

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www.drinkerbiddle.com

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Jonathan I. Epstein and Andrew B. Joseph, Partners in Charge of the Princeton and Florham Park, N.J., offices, respectively.

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