Division of Investment Management

Investment Company Liquidity Risk Management Programs Frequently Asked Questions

The staff of the Division of Investment Management has prepared the following responses to questions related to the investment company liquidity risk management ("LRM") program requirements adopted in October 2016 and expects to update this document from time to time to include responses to additional questions. These responses represent the views of the staff of the Division of Investment Management. They are not a rule, regulation, or statement of the Commission, and the Commission has neither approved nor disapproved this information. The Adopting Release for investment company LRM programs ("Adopting Release") is available at: https://www.sec.gov/rules/final/2016/33-10233.pdf. We define "rule" as Rule 22e-4 under the Investment Company Act.

Sub-Advised Funds

1. Q. The rule defines "person(s) designated to administer the program" as "the fund or In-Kind ETF's investment adviser, officer, or officers (which may not be solely portfolio managers of the fund or In-Kind ETF) responsible for administering the program and its policies and procedures . . . ." May the program administrator delegate responsibilities to a sub-adviser under the fund's liquidity risk management program, subject to appropriate oversight?

A. Yes. The rule requires a fund to adopt and implement a written LRM program, with a board-approved "person(s) designated to administer the program" ("program administrator"). The Adopting Release explains that the term "adviser" as used in the Adopting Release and the rule generally refers to any person, including a sub-adviser, that is an "investment adviser" of an investment company.[1] A fund's sub-adviser could thus be designated as program administrator.[2]

The Commission also recognized in the Adopting Release that sub-advisers could serve as third parties who could assist the program administrator in managing liquidity risk.[3] Thus, the staff believes that the program administrator also could delegate specific responsibilities to a sub-adviser under the fund's LRM program (*e.g.*, providing liquidity classifications for the fund's investments). Neither the rule nor the Adopting Release prescribes whether or how a program administrator could delegate responsibilities—either for administering the entire LRM program or for handling discrete responsibilities under the fund's LRM program. Therefore, the staff believes that, subject to appropriate oversight, a program administrator has flexibility regarding delegation, provided that each responsibility is delegated to, and assumed and handled by, an appropriate entity. We note, however, that the fund at all times retains ultimate responsibility for complying with the rule, and the program administrator is responsible under the rule for the administration of the LRM program. A fund may wish to implement policies and procedures regarding the scope of

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1 *See* Adopting Release at footnote 279 and accompanying text.

2 *See* Adopting Release at footnote 810 and accompanying text.

3 *See* Adopting Release at footnote 818 and accompanying text.

and conditions on permitted delegation of responsibilities by the program administrator, and the program administrator may in turn wish to implement policies and procedures to oversee those to whom it has delegated responsibilities under the LRM program, including sub-advisers if applicable to ensure that those responsibilities are appropriately fulfilled. Similarly, a fund's policies and procedures may permit an entity with delegated responsibilities to appoint sub-delegates and task them with handling certain portions of its delegated responsibilities, provided that the entities with sub-delegated authority are appropriately supervised.

2. Q. Does an adviser (including a sub-adviser) have an independent obligation to adopt and implement a liquidity risk management program?

A. No. The rule requires funds—not advisers—to adopt and implement LRM programs. However, the staff believes that the rule and Adopting Release clearly contemplate a role for advisers and their personnel in handling responsibilities under funds' LRM programs. For example, as discussed in response to ~~Question~~Q. 1, this role could take the form of administering funds' LRM programs or handling specific program responsibilities delegated by the program administrator.[4]

3. Q. In the staff's view, may an adviser (including a sub-adviser) administer, or have specific delegated responsibilities under, multiple fund LRM programs that differ from one another?

A. Yes. The staff recognizes that (i) an adviser (including a sub-adviser) may provide advisory services to multiple funds (including funds in multiple fund complexes), and (ii) funds, advisers, and sub-advisers currently assess, manage, and review liquidity risk using a diverse set of practices. The Adopting Release acknowledges the need for a fund's LRM program to be appropriately tailored to the fund's risks and circumstances, and the staff believes the rule's framework accommodates, and is fully consistent with, continued diversity and evolution of liquidity risk management practices.[5] An adviser (including a sub-adviser) may have responsibilities under multiple fund LRM programs that differ from one another (including multiple programs within the same fund complex), and the staff believes that such an adviser is under no obligation to reconcile the elements of those programs; the programs' underlying methodologies, assumptions, or practices; or the program outputs (*e.g.*, liquidity classifications of fund investments).

4. Q. If an adviser (including a sub-adviser) has responsibilities under multiple fund LRM programs, either in its role as the designated program administrator or under specific delegated responsibilities, which program should control for a particular fund?

A. Notwithstanding the diversity of fund LRM programs under which an adviser (including a sub-adviser) may have responsibilities, each fund's board-approved LRM program will control how an adviser or sub-adviser carries out any of its responsibilities under the rule (*e.g.*, liquidity classification of the fund's investments).

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[4] *See e.g.,* Adopting Release at footnote 66 and accompanying text.

[5] *See* Adopting Release at footnote 180 and accompanying text.

5. Q. May different funds classify the same investment differently?

A. Yes. As the Commission stated in the Adopting Release, the Commission recognizes that different funds may classify the liquidity of similar investments differently based on the facts and circumstances informing their analysis.[6] This could result in classifications of the same investment that vary from fund to fund. Under the rule, a fund must take into account "relevant market, trading, and investment-specific characteristics" in classifying its portfolio investments' liquidity, as well as the investments' market depth, based on trades of the size that a fund would "reasonably anticipate trading." Funds—including funds in the same complex—could use differing methodologies and assumptions with respect to the market, trading, and investment-specific characteristics, as well as market depth and reasonably anticipated trade size, and thereby appropriately arrive at different classifications for the same instrument.

6. Q. If a fund's adviser and sub-adviser (assuming it has one) have differing conclusions regarding an investment's appropriate liquidity category, how should the fund's liquidity program policies and procedures address those differences?

A. In the staff's view, a fund's program administrator could delegate responsibility for the classification of investments to either its adviser or sub-adviser, in which case that entity's decisions would control how the fund classifies its investments. Alternatively, the program administrator could adopt an approach where the adviser and sub-adviser(s) each have some input into the fund's liquidity classifications. In the latter case, and for a variety of reasons (including those set forth in the response to ~~Question~~Q. 5 above), a fund's adviser and sub-adviser may reach differing conclusions regarding an investment's appropriate liquidity category. Therefore, the staff believes that the fund's LRM program policies and procedures could address how the fund would resolve those differences. For instance, the staff believes that a fund's policies and procedures could stipulate that, in the event of a classification difference, a specified party's determination (*e.g.*, program administrator, adviser, or sub-adviser) would control, or establish another method (*e.g.*, a factor analysis or hierarchy or adopt the most conservative (*i.e.*, least liquid) classification) for resolving classification differences. These examples are meant to be illustrative only, and fund LRM programs could employ other ways of addressing any differences.

7. Q. Suppose that (i) a fund has multiple sub-advisers, each with discretion to manage its own distinct "sleeve" (a "manager-of-managers" structure), (ii) the fund's sub-advisers have been delegated responsibility under the liquidity program for classifying the investments in the sub-advisers' respective sleeves, and (iii) more than one sleeve holds the same investment. If each sub-adviser classifies the commonly-held investment differently, in the staff's view must the program administrator reconcile those differences for purposes of compliance with the rule?

A. Much like in the case of an adviser and sub-adviser discussed in ~~question~~Q. 6, in a manager-of-managers structure, the staff recognizes that multiple sub-advisers may have differing views regarding the appropriate liquidity category for their investments. Sub-advisers may manage their respective sleeves autonomously, with no reference to (or visibility into) the other

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6 *See* Adopting Release at footnote 311 and accompanying text.

sleeves. Consequently, just as funds (including funds within a complex) may classify the same investment differently, so too may sub-advisers of the same fund, because they may be guided by differing assumptions and methodologies. If such classification differences were to arise, the staff believes that neither the fund, program administrator, nor the adviser nor the sub-advisers with delegated LRM responsibilities would be under any obligation to resolve these differences for compliance purposes (*e.g.*, in connection with monitoring for compliance with the fund's highly liquid investment minimum (if applicable) and the 15% limit on illiquid investments). The staff believes, however, that a fund's policies and procedures could have a process for resolving these differences, similar to those discussed in ~~Question~~Q. 6.

As discussed below, however, a fund must reconcile such classification differences for purposes of reporting on Form N-PORT.

8. Q. If a fund that operates under a manager-of-managers structure classifies the same investment held in multiple sleeves differently as outlined above for compliance purposes, how should the fund report the investment's liquidity classification on Form N-PORT?

A. Form N-PORT does not permit a fund to report more than one liquidity classification of a single investment. If, as outlined above, a fund classifies the same investment held in multiple sleeves differently for purposes of compliance with the rule, the staff believes that its policies and procedures should have a process for selecting a single classification for that investment for purposes of Form N-PORT reporting.

When determining the overall liquidity classification of an entire investment position classified differently by multiple sub-advisers, the staff believes that a fund may use any reasonable method for resolving this difference, so long as the fund applies that method consistently. The staff believes that the fund could, for example: (i) adopt the classification of the sub-adviser with the largest position in the investment; (ii) calculate a weighted average (based on each sub-adviser's classification and its respective position size) and round to the nearest classification; or (iii) use the most conservative (*i.e.,* least liquid classification). These examples are meant to be illustrative only, and fund LRM programs could employ other ways of determining a single classification for purposes of Form N-PORT reporting.

The staff encourages a fund that has diverging liquidity classifications for an investment for compliance purposes but a single classification for reporting that investment on Form N-PORT to note this in the Form's Explanatory Notes section. For example, a fund could describe which of the methods described above the fund used to resolve differences in the classification of a single investment. The staff notes that any information included in the Explanatory Notes section is non-public if it is related to a non-public reporting item, such as the item requiring a fund to report its monthly position-level liquidity classification information.[7]

ETFs

9. Q. In its discussion of circumstances under which an In-Kind ETF may use cash to meet redemptions, the Adopting Release states that such an ETF's use of cash may "correspond

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7 *See* General Instruction F of Form N-PORT.

to uninvested cash in the fund's portfolio (which, to the extent that this amount of cash equals the fund's cash position in the portfolio, would be an 'in-kind' redemption) . . . ." The Adopting Release then states that "if an In-Kind ETF were to use more than a *de minimis* amount of cash (as determined in accordance with its written policies and procedures) to meet redemptions (for any of the reasons discussed above or otherwise), it would not qualify as an In-Kind ETF . . . ." For purposes of defining and testing compliance with its *de minimis* cash amount, in the staff's view may an ETF exclude the amount of cash in redemption proceeds that is proportionate to the ETF's uninvested portfolio cash, irrespective of amount?

A. Yes. The Commission specifically recognizes in the Adopting Release that to the extent the amount of cash (*i.e.*, U.S. currency) in a redemption equals the fund's cash position in the portfolio, the redemption is "in-kind" and is not considered "cash" that is subject to the *de minimis* amount.[8] Therefore, the staff believes that an ETF may exclude cash in redemption proceeds that is proportionate to the ETF's uninvested portfolio cash for purposes of defining and testing compliance with its *de minimis* cash amount.

10. Q. In the event that an ETF is no longer able to qualify for the In-Kind ETF exception, must a fund immediately come into compliance with the classification and highly liquid investment minimum requirements of the LRM program?

A. The staff understands there are practical considerations that would prevent a fund that loses its status as an In-Kind ETF from coming into immediate compliance with these requirements of the LRM program. Therefore, the staff would not recommend enforcement action if such an ETF comes into compliance with these requirements as soon as reasonably practicable after the ETF no longer qualifies for the In-Kind ETF exception. The staff notes that an ETF must indicate in Item E.5 of Form N-CEN its current status as an In-Kind ETF for the reporting period.

11. Q. According to the Adopting Release, an In-Kind ETF's policies and procedures "would determine the amount of cash and the types of transactions that it will treat as *de minimis*" for purposes of qualifying as an In-Kind ETF. Notwithstanding the lack of a bright line test in the rule or Adopting Release for what constitutes a *de minimis* amount of cash, is there a *de minimis* cash amount that the SEC staff would view as reasonable?

A. The Adopting Release states that "ETFs that redeem more than a *de minimis* amount in cash can have substantially similar liquidity risks as mutual funds. . . ."[9] Those ETFs are, as stated in the Adopting Release, subject to the same LRM program requirements as mutual funds, including the rule's investment classification and highly-liquid investment minimum requirements. Defining what constitutes a *de minimis* amount of cash in its policies and procedures is a determination that the rule and Adopting Release leave to each ETF, and therefore what is *de minimis* may differ among ETFs.[10] The staff believes that it would be reasonable for an In-Kind

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8 *See* Adopting Release at footnote 852 and accompanying text.

9 *See* Adopting Release at footnotes 842-845 and accompanying text.

10 *Id.* ("An In-Kind ETF generally should describe in its policies and procedures…the circumstances in which the In-Kind ETF may use a *de minimis* amount of cash to meet a redemption and what amount of cash would

ETF to determine that if the percentage of its overall redemption proceeds paid in cash does not exceed 5% (subject to permissible exclusions, such as set forth in ~~Question~~Q. 9), such use would be *de minimis.*[11]

The staff further believes that an In-Kind ETF may determine that cash use of more than 5% in redemptions is *de minimis.* In making such a determination, the staff believes that an ETF should evaluate its particular facts and circumstances, including the ETF's LRM program and whether a redemption(s) in cash in excess of 5% could give rise to liquidity risks substantially similar to those of mutual funds.

However, the staff believes that, if an ETF's percentage of overall redemption proceeds paid in cash exceeds 10% (subject to permissible exclusions, such as set forth in ~~Question~~Q. 9), it would be unreasonable (subject to permissible exclusions, such as set forth in ~~Question~~Q. 9), to consider it a *de minimis* amount of cash for purposes of qualifying as an In-Kind ETF. The staff notes that this framework for assessing *de minimis* use of cash in the context of fund redemptions would not necessarily be representative of a *de minimis* amount in the context of other requirements under the federal securities laws.

12. Q. In its discussion of the "In-Kind ETF" definition and what would constitute a *de minimis* amount of cash thereunder, the Adopting Release notes that there may be circumstances under which an In-Kind ETF may use cash to meet redemptions. The Adopting Release then states, "[b]y way of example, an ETF that normally redeems in-kind, but delivers all cash to a single authorized participant [an "AP"] that elects to receive cash, would not be an ETF that uses a *de minimis* amount of cash." In the staff's view, does this statement indicate that an ETF engaging in a single redemption transaction consisting entirely of cash is necessarily precluded from qualifying as an In-Kind ETF under the rule?

A. In the staff's view, where an ETF has agreed to accommodate an AP's *election* to receive cash as a standard practice, that ETF may be exposed to the risks that the rule is generally designed to address, and thus would not be able to qualify as an In-Kind ETF. However, if the delivery of all cash to a single AP is at the ETF's discretion (and not the election of the AP to receive cash as a standard practice), then the choice to provide cash or in-kind redemptions would be under the ETF's control, and thus the ETF would not be exposed to the risk that it would need to sell investments to make a cash redemption in adverse liquidity situations. Accordingly, the staff believes that a redemption transaction consisting entirely of cash does not necessarily preclude an ETF from qualifying as an In-Kind ETF so long as such a redemption transaction as a proportion of the ETF's aggregate redemption transactions does not exceed the *de minimis* amount of cash defined in the ETF's policies and procedures, and the AP who receives the cash redemption is not an AP who has elected to receive cash redemptions as a standard practice.

13. Q. What methods may an In-Kind ETF use to test whether its cash use is *de minimis?*

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qualify as such.")

[11] *See* ~~question~~Q. 13 on methods an In-Kind ETF may use for this calculation.

A. Although the rule and Adopting Release do not prescribe a precise methodology for how an ETF should test to determine whether it continues to qualify as an In-Kind ETF (thus leaving this determination to each ETF), the staff believes that an In-Kind ETF may take a variety of reasonable approaches to determine whether its cash use is *de minimis*, so long as the approach the ETF selects is consistently applied. For example, the staff would not object if an In-Kind ETF were to determine that a reasonable approach might include (i) testing each individual redemption transaction, to ensure that each has no more than a *de minimis* cash amount, or (ii) testing its redemption transactions in their totality over some reasonable period of time to ensure that, on average, its aggregate redemption transactions have no more than a *de minimis* cash amount.[12] The staff believes that a reasonable period of time for a fund with frequent redemption basket activity might be a day or a week, while a reasonable period for a fund with less frequent redemption basket activity may be up to a month. The staff does not believe that using a period of time over a month would be reasonable. 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*. Regardless of the method used, the staff believes that the ETF's policies and procedures should describe the ETF's approach for testing compliance and the time period used, and they should be applied consistently.

14. Q. The Adopting Release also states that an ETF that has lost its status as an In-Kind ETF "may be able to conclude that it qualifies as an In-Kind ETF in later years if such circumstances are not repeated." Does it follow from this that an ETF must wait, in all circumstances, at least two years before it can re-qualify as an In-Kind ETF?

A. No. The staff believes that there is no specific period of time that a fund must wait before it can determine that it once again qualifies as an In-Kind ETF. As noted in ~~question~~Q. 10 above, an In-Kind ETF that loses its status should come into compliance with these requirements as soon as reasonably practicable after the ETF no longer qualifies for the In-Kind ETF exception. However, the staff believes that the determination of whether an ETF qualifies as an In-Kind ETF after such status has been lost is a facts and circumstances determination. The staff believes that an ETF that loses its status as an In-Kind ETF should consider whether it is it appropriate to avail itself of the In-Kind ETF exemption, in light of the statement in the Adopting Release that an In-Kind ETF's written policies and procedures should describe how it analyzes its ability to redeem in-kind in all market conditions such that it is unlikely to suddenly fail to qualify for the exception.[13] Nonetheless, the staff believes that an ETF that lost its status as an In-Kind ETF could potentially avail itself of the In-Kind ETF exception again if it makes a reasonable determination, based on its particular facts and circumstances, that the event that caused it to lose its status as an In-Kind ETF was an extraordinary one-time event that is unlikely to occur again. The staff believes that such an ETF should describe the factors it generally would consider in making this determination in its policies and procedures.[14]

15. Q. May an ETF, including an ETF with little or no operating history, consider factors other than its redemption history in determining whether it qualifies as an In-Kind ETF?

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12 *See* Adopting Release at footnote 854 and accompanying text.

13 *See* Adopting Release at footnote 854 and accompanying text.

14 *See* Adopting Release at footnote 854 and accompanying text.

A. Although the staff believes that an ETF's backward-looking redemption history is ordinarily relevant in determining whether it qualifies as an In-Kind ETF, it is not, by itself, dispositive. The staff believes that an ETF's "in-kind" analysis also may have a forward-looking component. For example, the staff believes that a new ETF could conclude that it qualifies as an In-Kind ETF based on an analysis of its policies and procedures and its expected redemption practices.

In addition, the staff believes that an ETF with an operating history could consider material changes to its policies and procedures and redemption practices and their anticipated effects. For instance, the staff believes that if an ETF changes its policies and procedures to restrict its ability to meet redemptions using cash, and if the ETF otherwise reasonably concludes that its use of cash to meet redemptions is likely to decline to a *de minimis* level and reasonably expects to maintain such levels going forward, depending on the circumstances it may determine that it qualifies as an In-Kind ETF, notwithstanding recent redemption transaction history, based on an analysis of material changes made to its policies and procedures to maintain compliance.

Asset Class Liquidity Classification

16. Q. A fund may classify and review portfolio investments according to their asset classes, provided that it has a process for separately classifying and reviewing "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." How may a fund approach this exception process?

A. The staff believes that a fund choosing to use an asset class method of investment classification may identify liquidity characteristics it *reasonably expects* would make an investment a *significant* departure from the range of liquidity characteristics present within its asset class.[15] Put differently, different investments within an asset class may be expected to exhibit a range of varying liquidity profiles. The staff does not believe that investments falling within that range should trigger this process. Moreover, not every deviation in an investment's liquidity characteristics from those of the range of others in its asset class should trigger separate review and classification, but rather only the ones that have a significant effect on those liquidity characteristics. The staff recognizes that more sensitive exception methodologies may result in numerous false positives, which would limit the utility of this asset classification method in identifying true significant outliers, thereby undermining the balance the Commission sought to strike in permitting class-based classification.

17. Q. How may a fund wishing to classify and review investments according to their asset classes identify exceptions?

[15] *See, e.g.*, Liquidity Adopting Release at text accompanying n 436 (discussing how a particular investment should be classified differently than its asset class if its market was "exceptional in terms of size, breadth or depth" or if the bid-ask spreads were "generally wider, narrower or more volatile" than other assets in the class).

A. The staff believes that a fund relying on this classification method should include in its policies and procedures a reasonable framework for identifying exceptions to asset class classifications.[16] This framework may rely on automated processes. The staff believes that a fund which has such a reasonable framework may generally rely on the results of those processes, and need not subsequently justify every classification on a CUSIP-by-CUSIP basis. The staff expects, however, that a fund making use of a reasonable framework, or automated processes, would conduct periodic testing of the framework and processes to determine whether they are properly identifying those investments meriting treatment as an exception to the class-based classification as part of their required review of the adequacy and effectiveness of the liquidity risk management programs' implementation.

18. Q. If a fund identifies a potential exception when using an asset class methodology approach, must it immediately reclassify that investment?

A. The staff believes that there is no presumption that a fund that identifies *potential* exceptions must necessarily reclassify them. Upon further review, a fund may conclude that classification of the investment with other investments within the same asset class is still appropriate, even if the liquidity characteristics of the investment has changed, because the particular investment's liquidity remains within the liquidity bucket assigned to the asset class as a whole.

Reasonably Anticipated Trading Size

19. Q. Liquidity classification of investments requires consideration of the "sizes that the fund would reasonably anticipate trading" and market depth. If a fund classifies investments based on their asset class or classes, how may it consider this market depth factor?

A. A fund that classifies investments based on asset class is subject to rule 22e-4(b)(l)(ii)(B), which applies to classifications of "portfolio investments or asset classes (as applicable)." The staff believes that this provision permits an aggregated analysis for those investments that a fund classifies by asset class (*see* Q. 17 for a discussion of how exceptions to an asset class may be identified). For example, if a fund has identified "Asset Class X" as appropriately grouped together, then for purposes of this analysis, the staff believes that the fund could arrive at reasonably anticipated trading sizes for all of its "Asset Class X" investments, and use those reasonably anticipated trading sizes in classifying all of its "Asset Class X" investments. When a fund uses aggregated reasonably anticipated trading sizes for asset classes that have positions of widely varying size in its portfolio, the staff believes that the fund should consider whether using fixed dollar amounts is a reasonable approach (instead of using percentages of the full position), because using fixed dollar amounts on positions of widely varying size may result in unreasonable trading sizes in some cases.

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16 *See, e.g.*, Liquidity Adopting Release at text accompanying n. 435 (discussing how reasonably designed policies and procedures would "likely include specifying the sources of inputs that inform its exception processes" and the "particular variables that could affect the fund's classification of certain investments.").

20. Q. When a fund conducts the market depth analysis for an investment, must the fund consider amounts it would "reasonably anticipate trading" for reasons other than meeting redemptions, or liquidity risk management generally?

A. The staff believes that determining sizes that the fund reasonably anticipates trading does not require funds to predict which specific portfolio positions it will sell in advance or consider actual trades executed for reasons other than meeting redemptions. Funds may sell portfolio positions for reasons that are unrelated to meeting investor redemptions or liquidity risk management. As discussed in Q. 21, the staff believes that a fund may make a reasonable assumption about the sizes that it will reasonably anticipate trading, and use that assumed size throughout its classification process. A fund could continue to use that assumed reasonably anticipated trading size even in cases where a fund anticipates fully liquidating a position for investment reasons (*e.g.*, because holding it is no longer consistent with the fund's investment objective or strategy) in the near term.

21. Q. When a fund conducts the market depth analysis for an investment, must the fund determine precisely what it would sell, in particular quantities, and in a particular sequence in response to redemptions?

A. In determining a reasonably anticipated trading size for each portfolio investment or asset class (as applicable), the staff does not believe that a fund should attempt to predict its future portfolio management decisions related to meeting redemptions, but rather should estimate a portion of an investment that it reasonably believes it could choose to sell to meet redemptions. Accordingly, the staff believes that it may be appropriate for a fund to make certain simplifying assumptions in conducting this analysis and arriving at reasonably anticipated trading size assumptions. For example, a fund could conclude that selling all portfolio investments *pro rata* in response to a redemption would be a reasonable baseline assumption (notwithstanding that actual amounts sold could be higher or lower than a *pro rata* assumption would indicate), and determine reasonably anticipated trading sizes accordingly. The staff believes that funds also could consider other assumptions, as they deem appropriate. Ultimately, the rule requires that the fund make assumptions about the sizes that that the fund would anticipate trading in a reasonable manner, but does not specify a particular method of doing so. The staff believes that a zero or near zero reasonably anticipated trade size would not be a reasonable assumption, as it would transform any illiquid assets into highly liquid assets in a manner inconsistent with the Commission's goals in adopting rule 22e-4.

Price Impact Standard

22. Q. In classifying an investment, a fund must consider how quickly it may convert the investment to cash (or sell or dispose of it, as applicable) "without [ ] significantly changing the market value of the investment." Must a fund employ a single, fixed numerical price impact assumption in classifying all of its investments?

A. The staff believes that a fund has the flexibility to establish the meaning(s) of what constitutes a "significant change in market value" in its policies and procedures. The staff recognizes that these price impact assumptions are subjective, due to the variety of inputs that may reasonably be used by any fund or portfolio manager. Accordingly, the staff believes that what constitutes a significant change in market value may vary by fund, asset class, or investment. Therefore, the staff believes that a fund does not need to employ as a price impact assumption 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

23. Q. How may a fund approach liquidity classification of an investment in another pooled investment vehicle (*e.g.*, a mutual fund, ETF, closed-end fund, or private fund)?

A. The rule's investment classification requirements and category definitions are predicated on how long it would take a fund to convert an investment to cash, or sell or dispose of the investment (depending on the category). The staff believes that a fund that invests in other pooled investment vehicles ("pools") may focus on the liquidity of the pool's shares or interests when classifying those investments. For pool shares that trade on exchanges (*e.g.*, shares of ETFs and closed-end funds), the staff believes that it may be appropriate for a fund to evaluate their liquidity in much the same way that it would evaluate the liquidity of other exchange-traded investments (*e.g.*, common stock), and generally only "look through" to the pool's underlying investments under circumstances when the fund has reason to believe that doing so could materially alter its view of the liquidity of the pool's shares.[17]

For pools that offer redeemable securities or withdrawal rights (*e.g.*, mutual funds or private funds), the staff believes that a fund generally would focus on the pool's ordinary redemption rights or practices, and "look through" to the pool's underlying investments only under circumstances when the fund has a reason to believe that the pool may not be able to honor those rights or meet redemptions in accordance with its customary practice.

Provisional Investment Classification Activity and Related Compliance Monitoring

24. Q. How frequently should a fund conduct reviews to ensure compliance with its highly liquid investment minimum (if applicable) and the 15% limit on illiquid investments?

A. These requirements are critical to the functioning of rule 22e-4, and as such, the staff believes that regular monitoring is essential to compliance with the rule. Several factors affect a fund's compliance with these requirements. These include a change in the value or size of an existing investment, the acquisition of a new investment and the reclassification of an existing investment. The staff believes a fund should calculate the value of existing investments for this purpose in conjunction with its daily computation of net asset value. The staff believes a fund should classify newly acquired investments as discussed in Q. 27 and should reclassify existing investments under the circumstances discussed in Q. 28. The staff notes that monitoring for compliance with these limits does not require a fund to reclassify its existing investments on a daily basis, because the fund may use the classifications that it last verified and determined as part of this monitoring process (generally the last reported classification on Form N-PORT).

[17] *See, e.g.*, Liquidity Adopting Release at text following n. 524 (discussing certain circumstances where a fund may wish to look through an ETF to its underlying holdings if those holdings' liquidity may impair the liquidity of the ETF).

25. Q. May a fund voluntarily choose to provisionally classify an investment at times other than its required monthly classification?

A. As used in these FAQs, a "provisional classification" is any liquidity classification other than a final classification determination reported to the Commission on Form N-PORT or verified reclassifications made pursuant to an intra-month compliance monitoring (*see* Q. 24). Use of provisional classification is voluntary and the rule does not require a fund to use it. The staff believes that such a provisional classification could include any form of liquidity classification (made pursuant to the classification provisions of rule 22e-4 or otherwise) that the fund chooses to use as part of its liquidity management program.

A fund may conclude that a voluntary provisional classification may assist it in assessing and managing its liquidity risk. It also may be helpful in a fund's efforts to enhance its program by improving the quality of classifications. The staff recognizes that a fund may employ other means of assessing and managing liquidity risk that the rule does not specifically require (particularly with respect to assessing the liquidity of portfolio investments), and the staff believes that the rule's intent is not to dissuade a fund from employing liquidity risk management practices that go beyond what is required in the rule and that the fund finds beneficial. *See also* Q. 32.

26. Q. If the fund's compliance monitoring, or, if a fund uses provisional classifications, provisional classifications suggest that the fund may have fallen below its HLIM (if applicable) or exceeded the 15% limitation on illiquid investments, would it trigger obligations to report to the board or SEC?

A. The staff believes that funds should review provisional classifications (if used) and compliance monitoring that indicates the potential occurrence of such an event in accordance with the funds reasonably designed policies and procedures. The staff believes that if the fund verifies and determines that the fund has in fact fallen below its HLIM or exceeded the 15% limitation on illiquid investments, based on compliance monitoring or by finalizing a provisional reclassification according to its policies and procedures, the fund would be subject to the applicable reporting requirements. Every fund subject to rule 22e-4 must at all times comply with the rule's requirements relating to its 15% illiquid investment limit and HLIM.

Timing and Frequency of Classification of Investments

27. Q. When must a fund initially classify a newly acquired investment, or consider for reclassification an investment in which the fund has increased or decreased its position?

A. The rule does not specify when a fund initially must classify a newly acquired investment, but requires at least monthly review of the classifications status of the investments held in a fund's portfolio.[18] The staff would not object if a fund classifies a newly acquired investment, or considers for reclassification an investment in which the fund has increased or decreased its position, during its next regularly scheduled monthly classification, except as noted in Qs 28 (intra-month re-evaluations) and 31 (illiquid investments).

[18] *See* rule 22e-4 (b)(1)(ii).

28. Q. A fund must classify its investments at least monthly in connection with its Form N-PORT reporting obligations, and "more frequently if changes in relevant market, trading, and investment-specific considerations are reasonably expected to materially affect one or more of its investments' classifications." What are the SEC staff's views on intra-month classification reviews?

A. As discussed in section III. C. 5 of the Release, a fund generally is not required to reassess its investments' liquidity classification on an intra-month basis. Instead, rule 22e-4 requires 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. The staff does not believe that this intra-month review requirement creates a *de facto* ongoing review requirement for classification. The staff would not object if a fund complies with this intra-month review obligation by identifying in its policies and procedures events that it reasonably expects would materially affect an investment's classification. The staff would not object if reasonable policies and procedures limits such events to those that are objectively determinable (*e.g.*, a trading halt or delisting of a security, an issuer or counterparty default or bankruptcy, significant macro-economic developments (such as a sovereign default), or events like extraordinary natural disasters or political upheavals, for funds with concentrated geographic exposures).

29. Q. If a change occurs that triggers an intra-month classification review, must the fund re-classify all of its investments or just the ones affected by the change?

A. The staff believes that a fund must review and determine whether to reclassify only those particular investments that the fund reasonably expects to be materially affected by the change in question.

Pre-trade Activity and the 15% Limitation on Illiquid Investments

30. Q. Must a fund classify an investment that it is purchasing (or considering purchasing) on a pre-trade basis?

A. No. The rule requires a fund to "classify each of the fund's portfolio investments" and review those classifications at least monthly thereafter. A fund is not required to classify an investment (or conduct any related compliance monitoring) prior to acquisition.

31. Q. For purposes of the 15% illiquid investment limit, how should a fund meet its obligations with respect to intra-month investment acquisitions when it generally classifies its investments at the end of the month, or is an in-kind ETF that is not subject to the classification requirements?

A. The staff believes that a fund should implement reasonably designed policies and procedures to appropriately limit illiquid investments, so that the fund will not acquire any illiquid investment that would cause it to exceed this 15% limitation. However, as discussed in Q. 30, this does not require the fund to engage in pre-trade classification. The staff believes that one reasonable method for a fund to comply with the 15% illiquid investment limit with respect to acquisitions is to preliminarily identify certain asset classes or investments that the fund reasonably believes are likely to be illiquid ("preliminary evaluation"). We expect that the fund could base this reasonable belief on its previous trading experience (including its experience in the investment's typical market depth and price impact when trading), on its understanding of the general characteristics of the asset classes it is preliminarily evaluating, or through other means. A fund could choose to determine that certain investments identified in such asset classes that it purchases are illiquid based solely on this preliminary evaluation, and not engage in any further analysis under the rule at that time. Alternatively, if the preliminary evaluation establishes a reasonable basis for believing that an investment is likely to be illiquid, but the fund wishes to further evaluate its status, the fund may then, as a secondary step, determine whether it is an illiquid investment using the classification process set forth in rule 22e-4. Investments in asset classes the fund acquires that it does not reasonably believe are likely to be illiquid would not need to be classified when performing this preliminary analysis. Funds would then review the liquidity of all of their holdings, including all new acquisitions, as part of their monthly classification review. As discussed in the guidance provided in the Liquidity Delay Release[19], In-Kind ETFs should also review the illiquid status of their investments at least monthly, or more frequently in certain circumstances.

The staff believes funds could automate such a preliminary evaluation of asset classes or investments, and they could base that evaluation on the general characteristics of the investments the fund purchases. For example, in establishing the list of asset classes or investments that the fund believes have a reasonable likelihood of being illiquid, the fund could take into account the trading characteristics of the investment (for example, whether it is a restricted security or has structural liquidity limitations, the trading history of the asset class, or whether the investment typically requires significant negotiations to trade) and use such characteristics to form the reasonable belief of illiquidity.

In evaluating the likelihood of an asset class or investment being illiquid, we do not believe it would be reasonable to assume that a fund is only selling a single trading lot when looking at the market depth of the asset or class. However, a fund would not need to evaluate the actual size of its holdings in the asset class or engage in the full process of evaluating its reasonably anticipated trading size for the asset class under the rule. Instead, a fund could use any reasonable method in evaluating the market depth of the asset classes or investments it identifies as likely being illiquid in the preliminary evaluation.

Much as discussed in Q. 17, the staff believes that a fund making use of a preliminary evaluation, or using automated processes, would conduct periodic testing of the framework and processes to determine whether they continue to be accurate as part of their required review of the adequacy and effectiveness of the liquidity risk management programs' implementation.

Funds may use other reasonable approaches as well. For example, a fund often will not be at risk of violating this provision when it acquires illiquid investments if a fund's current percentage of illiquid investments is well below 15%, and therefore an acquisition of an illiquid investment generally may not cause the fund to exceed the limitation (unless the investment's size in relation to the fund's net assets were quite large). Accordingly, the staff believes that a reasonable

[19] *See* 15% guidance in Investment Company Liquidity Risk Management Programs; Commission Guidance for In-Kind ETFs, Investment Company Act Release No. IC- IC-33010 (Feb. 22, 2018) ("Liquidity Delay Release").

approach may be for the fund's policies and procedures to require additional monitoring in reviewing acquisitions as the fund's percentage of illiquid investments increases. For example, if an acquisition could cause a fund to exceed the 15% limitation, the fund's procedures could prohibit the acquisition of (i) investments within certain asset classes that the fund deems to be presumptively illiquid, regardless of position size (*e.g.*, investments that have restrictions on transferability), (ii) additions to investments that the fund has classified as illiquid investments as of the most recent finalized classification for each investment, and/or (iii) investments the fund has provisionally classified as illiquid investments.

We note that the staff believes that the methods discussed above would be reasonable approaches for a fund to help assure itself that it has not violated either the 15% illiquid investment limit or the HLIM during the intra-month period between scheduled classifications. Nonetheless, if the fund's classification process indicates that the fund violated either of these limits, as discussed in Qs 32 and 33 below, a fund would be required to report such events on Form N-LIQUID and to its board.

Related Reporting Requirements

32. Q. Rule 22e-4, rule 30b1-10, and Form N-LIQUID require reporting to the fund board and SEC within certain prescribed periods when a fund has exceeded the 15% limitation on illiquid investments, or fallen below its highly liquid investment minimum (if applicable). When does such a reportable event occur?

A. As a general matter, a reportable event occurs under the rule when a fund exceeds the 15% limitation on illiquid investments or has fallen below its HLIM (if applicable) (*see* Q. 26). The staff understands, however, that a fund may potentially exceed a limit if, for example, the fund's policies and procedures require a fund to determine whether to reclassify an investment when a third party service provider's system or a sub-adviser reclassifies one or more of a fund's investments. In other cases, a provisional classification may indicate a liquidity issue, but the fund has not yet verified and made a final determination that such an issue actually exists. In these circumstances, a fund may need a reasonable amount of time to determine and verify for itself the impact and validity of the reclassification on the fund's compliance with its limits. In general, the staff believes that this verification and final determination process should be completed within three business days or less, including the day that the triggering event was observed. In those limited circumstances, the staff believes that a fund's reporting obligation would be triggered not by the event itself, but instead when the fund has determined and verified (within three business days of the event) that the fund has in fact exceeded the 15% illiquid investment limit or fallen below its HLIM (if applicable) (*see also* Q. 33 for guidance on reporting the time period for the event on Form N-LIQUID in such cases).

33. Q. The rule states that (i) a fund's highly liquid investment minimum may not be changed during any period of time that the fund's assets that are highly liquid investments are below the determined minimum without approval from the fund's board of directors, including a majority of directors who are not interested persons of the fund, and (ii) if a fund experiences a shortfall in its highly liquid investment minimum that lasts more than 7 consecutive calendar days, it must report certain information to its board. Form N-PORT requires a fund to disclose the number of days the fund's holdings in highly liquid investments fell below its highly liquid investment minimum. Similarly, Form N-LIQUID

requires a fund to disclose specific dates on which the fund's investments (i) exceeded or returned to or below the 15% limitation on illiquid investments, and (ii) fell below its highly liquid investment minimum. How should a fund identify these periods?

A. As discussed in Q. 32, once a fund has determined and verified that a reportable event has occurred because it is not in compliance with one or both of these limits, the staff believes that the time period begins for how long the fund has to report the event to the Commission or its Board. However, the periods of time reported on Form N-LIQUID or to the board as a result of the event should also include the additional days, if any, during which the fund engaged in determining and verifying that it is not in compliance after the triggering event took place. For example, a fund might purchase an asset that made it exceed the 15% illiquid asset limit on a Monday, verify and determine that the asset was illiquid and that the fund was out of compliance on a Wednesday, and report the event to the Commission on a Thursday. In the report, it should indicate that the fund was out of compliance beginning on Monday, on the trade date of the event that led to the fund being out of compliance with the relevant limit, and not as of the Wednesday when it was verified and determined. Form N-LIQUID is a text form that requires funds to report the date(s) that a fund was out of compliance with the HLIM or 15% illiquid investment limit, and funds may thus wish to indicate on the form both the date of the triggering event and the date it was determined and verified to address any ambiguity.

ETFs and Investment Classification

34. Q. An ETF may not qualify as an "in-kind ETF" (and therefore would be subject to the rule's investment classification requirements and potentially its highly liquid investment minimum requirements), but may nevertheless satisfy a large percentage of its redemptions in-kind. May this be relevant for how such an ETF (or fund that uses in-kind redemptions) classifies its investments and sets its highly liquid investment minimum?

A. Rule 22e-4's classification requirement is predicated on how long it would take a fund to convert an investment to cash, or sell or dispose of the investment (depending on the category). An ETF does not convert to cash (or sell or dispose of) investments that it distributes in-kind to meet redemptions. An ETF that does not meet the definition of In-Kind ETF but nevertheless redeems shares in-kind to any material extent may have a different liquidity profile, and face different liquidity risks, than a similar one that does not. Accordingly, the staff believes that it may be appropriate for such an ETF to reflect these differences in its classification procedures and in designating a highly liquid investment minimum. On the other hand, increasingly less liquid assets may be more difficult or costly for an ETF to transfer in-kind. In addition, the staff believes that a zero or near zero reasonably anticipated trade size would transform any illiquid assets into highly liquid assets in a manner inconsistent with the Commission's intent in adopting rule 22e-4. Further, the staff believes that the rule's reasonably anticipated trading size requirement presupposes a size greater than a single trading lot.

Balancing these considerations, the staff believes that an ETF could take reasonably anticipated in-kind redemption activity into account when determining appropriate reasonably anticipated trading size or market depth assumptions for its investments. When using in-kind redemptions, the staff believes that an ETF should set an appropriate minimum trade size that takes into account the liquidity considerations discussed above.

This guidance would apply to any mutual fund that redeems in-kind to any material extent. The staff believes this is consistent with the policy repeated often in the Adopting Release, that each fund—including an ETF—should design its liquidity risk management program, including its investment classification methodology and its highly liquid investment minimum, based on the fund's particular liquidity considerations and risks.

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