NEW LIQUIDITY RISK MANAGEMENT PROGRAM

The Securities and Exchange Commission (SEC) adopted Rule 22e-4 in October 2016 that requires open-end investment funds to establish written liquidity risk management programs. The new rule is designed to enhance how open-end funds manage liquidity risk and improve how the SEC monitors and regulates the asset management industry.

OVERVIEW: WHAT ARE THE NEW RULES?

Rule 22e-4 requires all open-end funds, including mutual funds and exchange-traded funds but excluding money market and closed-end funds, to implement a formal, written liquidity risk management program. The new rules will enhance the disclosures of funds' liquidity practices and help the SEC address how funds' investments affect investors and the financial market. Under the new liquidity risk management program requirements, funds must:

- Assess, manage and periodically review liquidity risk
  - Funds may conduct principles-based assessment of liquidity risk
- Classify investments by asset class according to liquidity level: highly liquid, moderately liquid, less liquid, illiquid
- Determine a highly liquid investment minimum
  - Funds must set a minimum percentage of net assets to invest in highly liquid investments
- Establish a minimum liquidity threshold
  - Funds must adopt procedures to address any shortfalls in the minimum level of liquidity
  - Funds must file a report with the SEC when liquidity level falls below the minimum or when a fund exceeds a 15% limit on illiquid investments
- Grant program oversight to board of directors
  - Board must approve a fund's liquidity management program and designate a program administrator

Growth in shareholder flows and evolving redemption and settlement practices have created a focus on liquidity risk management in the open-end fund industry.

WHAT ARE THE PROGRAM COMPLIANCE DATES?

December 1, 2018 for investment companies with more than $1 billion in assets under management

June 1, 2019 for investment companies with less than $1 billion in assets under management

WHY IS THE SEC REQUIRING A WRITTEN LIQUIDITY RISK MANAGEMENT PROGRAM?

According to the SEC, recent industry developments, such as growth in shareholder flows, alternative strategies and evolving redemption and settlement practices, have created a focus on liquidity and liquidity risk management practices in open-end funds.

Rule 22e-4 is intended to reduce the risk that funds will not be able to meet their redemption obligations and to minimize dilution of remaining shareholders' interests. The new program requirements are expected to increase investment protection across the fund industry by strengthening liquidity risk management practices, disclosures and transparency.

WHAT CAN FUNDS DO TO PREPARE FOR COMPLIANCE?

- Set up or modify your internal liquidity risk management program and identify resources for providing liquidity and data analysis.
- Consider your program framework:
  - How will you modify and document your current liquidity risk management practices?
  - How will you align the program view for sub-advised or multi-managed funds?
  - What factors are specific to your funds and strategies? Consider lines of credit, interfund lending, distribution channels and daily flows.
  - Will you consider swing pricing, optional on November 19, 2018?
- Understand that classifying assets requires manager input; it's not an "off-the-shelf" service from data providers.
- Consider whether to build or buy the technology and infrastructure you'll need for compliance.
- Ensure your board understands your approach and their role.
- Talk to your service provider about how you'll integrate liquidity risk program data for fund filings.

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