

MEMO# 31274

July 3, 2018

SEC Adopts Liquidity Disclosure Amendments

[31274]

July 3, 2018 TO: ICI Members

Investment Company Directors SUBJECTS: Compliance
Disclosure

Exchange-Traded Funds (ETFs)

Fund Accounting & Financial Reporting

Fund Governance

Investment Advisers

Operations

Portfolio Oversight

Risk Oversight

Transfer Agency RE: SEC Adopts Liquidity Disclosure Amendments

The SEC approved amendments to open-end funds' liquidity-related disclosures last week.[\[1\]](#) The final amendments are similar to those that the SEC proposed in March,[\[2\]](#) which ICI strongly supported.[\[3\]](#) Most notably, the amendments: (i) rescind reporting and public disclosure of aggregated liquidity classification (or bucketing) information, and (ii) require funds, in their shareholder reports, to discuss in narrative form the operation and effectiveness of their liquidity risk management programs over the past year.

Background

The SEC adopted Rule 22e-4 (the "liquidity rule") and related reporting requirements in October 2016.[\[4\]](#) Since then, ICI has been working with members to implement these requirements. ICI also has continued its engagement with the SEC, submitting comment letters in July and November of 2017.[\[5\]](#) In February of 2018, the SEC adopted an interim final rule that extends by six months bucketing-related portions of the liquidity rule and related reporting requirements.[\[6\]](#) In March, the SEC proposed liquidity disclosure amendments, on which ICI provided comments.

Summary of Amendments to Form N-PORT

The amendments to Form N-PORT:

- Eliminate reporting to the SEC and public disclosure of aggregated bucketing information;
- Permit funds, when reporting investment-specific bucketing information to the SEC, to

- “split” an investment among buckets in three specific circumstances; and
- Require funds to report their holdings of cash and cash equivalents.

We discuss each below.

Elimination of Aggregated Bucketing Information

As adopted in 2016, Item B.8 of Form N-PORT would have required a fund to report the aggregate percentage of its portfolio investments that fall into each of the four liquidity buckets. This monthly reporting item would have been disclosed to the public for the third month of each fiscal quarter with a 60-day delay.

The final amendment to Item B.8 eliminates this aggregated bucketing reporting item. Funds therefore will not be required to provide bucketing information to the public. The SEC still would receive investment-specific bucketing information under Item C.7, which it presumably could aggregate for its own internal purposes. The Adopting Release outlines the concerns that commenters, including ICI, had voiced about public reporting of bucketing information.[\[7\]](#)

The SEC also adopted, as proposed, a related change to make non-public (but not eliminate) the reporting under Item B.8 of Form N-PORT about the percentage(s) of a fund’s highly liquid investments segregated to cover, or pledged to satisfy margin requirements in connection with, non-highly liquid derivatives transactions.

“Splitting” an Investment Among Liquidity Buckets

As adopted in 2016, Form N-PORT would have required a fund to classify each investment into a single liquidity bucket in all cases. The amendments to Item C.7—adopted nearly identically as proposed— permit (but do not require) a fund to split an investment into multiple buckets in three specified circumstances:

- if portions of the position have differing liquidity features that justify treating the portions separately;
- if a fund has multiple sub-advisers with differing liquidity views; or
- if the fund chooses to classify the position through evaluation of how long it would take to liquidate the entire position (rather than basing it on the sizes it would reasonably anticipate trading).[\[8\]](#)

Disclosure of Cash and Cash Equivalents

As adopted in 2016, Form N-PORT would not have required funds to specifically report the amount of cash and cash equivalents that they hold. New Item B.2.f.—adopted as proposed—will require funds to report “cash and cash equivalents not reported in Parts C and D.” The Adopting Release explains that this new disclosure item will “provide more complete information that will be useful in analyzing a fund’s HLIM [Highly Liquid Investment Minimum], as well as trends regarding the amount of cash being held, which also correlates to other activities the fund is experiencing, including net inflows and outflows.”[\[9\]](#) The Adopting Release looks to US generally accepted accounting principles for purposes of defining cash equivalents.

Summary of Amendments to Form N-1A (New Shareholder Report Disclosure)

Form N-1A currently requires no liquidity-specific disclosures in funds' shareholder reports. The proposed Form N-1A amendment would have required funds as part of Management's Discussion of Fund Performance (MDFP)(an annual report disclosure item), to "[b]riefly discuss the operation and effectiveness of the Fund's liquidity risk management program during the most recently completed fiscal year." The Proposing Release presented this as an alternative to public dissemination of bucketing information.

As adopted, Item 27(d)(7)(b) of Form N-1A requires the following: "If the board of directors reviewed the Fund's liquidity risk management program pursuant to rule 22e-4(b)(2)(iii) ... during the Fund's most recent fiscal half-year, briefly discuss the operation and effectiveness of the Fund's liquidity risk management program over the past year."[\[10\]](#) While the substance of this disclosure item is similar to the proposal's, it differs from the proposal in that (i) it now is outside the MDFP (the Adopting Release notes that the move would "avoid concerns about unduly focusing investors on liquidity risk and diluting the MDFP"), and (ii) funds now will have flexibility to cover an annual period that does not coincide with the fund's most recently completed fiscal year, and include the disclosure in an annual or semi-annual report (the Adopting Release explains that doing so "will allow funds to synchronize the required annual board review of liquidity risk management programs with the production of this discussion in the shareholder report, reducing costs and allowing funds to provide more effective disclosure").[\[11\]](#) The Adopting Release then provides guidance regarding how a fund may satisfy this new disclosure requirement.[\[12\]](#)

The Release also points out that to the extent a liquidity event materially affects a fund's performance, this event must be discussed in the MDFP.[\[13\]](#)

Other Noteworthy Items in Adopting Release

The Proposing Release requested comment on whether there were advantages to the Treasury report's suggestion that the SEC embrace a principles-based approach to bucketing [\[14\]](#) and, if so, what additional steps should be taken to shift towards such an approach.[\[15\]](#) After summarizing the comments received, the Adopting Release states that "funds that believe they would have to maintain dual liquidity classification programs as part of their liquidity risk management may choose to seek an

exemption from the Commission from the classification requirements of rule 22e-4 if they believe that their existing systems would effectively accomplish the Commission's stated goals."[\[16\]](#) The Adopting Release otherwise does not elaborate on the potential terms and conditions of this exemptive relief. Furthermore, the Adopting Release states that "the staff will analyze the extent to which the liquidity classification process and data are achieving the Commission's goals and any other feedback provided from interested parties to the Commission... [and] will then inform the Commission what steps, if any, the staff recommends in light of this monitoring."[\[17\]](#)

This represents an expansion of the staff's ongoing liquidity work, and the Adopting Release indicates that the staff's evaluation will take into account at least one full year's worth of bucketing data from large and small entities. By contrast, the Proposing Release contemplated only a staff analysis and recommendation to the SEC by June 2020 addressing whether and, if so how, there should be public dissemination of fund-specific bucketing information. Also, the Proposing Release indicated that the SEC staff anticipated publishing "aggregated and anonymized" information about the fund industry's liquidity

(gathered through Form N-PORT filings), whereas the Adopting Release states that the staff will consider whether publishing such aggregated and anonymized classification data would be useful, and include a recommendation as part of its overall liquidity evaluation.

Compliance Dates

As with the Form N-PORT and liquidity requirements generally, the SEC is maintaining a tiered set of compliance dates for “larger entities” and “smaller entities” for these amendments.^[18] For larger entities, the compliance date for the Form N-PORT amendments is June 1, 2019 (the first filing date will be July 30, 2019), and the compliance date for the Form N-1A amendments is December 1, 2019. For smaller entities, the compliance date for the Form N-PORT amendments is March 1, 2020 (the first filing date will be April 30, 2020), and the compliance date for the Form N-1A amendments is June 1, 2020.

Matthew Thornton
Assistant General Counsel

Dorothy M. Donohue
Deputy General Counsel - Securities Regulation

Gregory M. Smith
Senior Director, Fund Accounting and Compliance

endnotes

^[1] *Investment Company Liquidity Disclosure*, SEC Release No. IC-33142 (June 28, 2018)(“Adopting Release”), available at www.sec.gov/rules/final/2018/ic-33142.pdf. Chairman Clayton and Commissioners Piwowar and Peirce voted in favor of the package of disclosure amendments, and Commissioners Stein and Jackson voted against it.

^[2] *Investment Company Liquidity Disclosure*, SEC Release No. IC-33046 (Mar. 14, 2018)(“Proposing Release”), available at www.sec.gov/rules/proposed/2018/ic-33046.pdf. See Institute [Memorandum No. 31136](#), dated March 16, 2018, for a detailed summary of the proposal.

^[3] ICI’s comment letter is available at www.sec.gov/comments/s7-04-18/s70418-3669117-162439.pdf.

^[4] *Investment Company Liquidity Risk Management Programs*, SEC Release No. IC-32315 (Oct. 13, 2016), available at www.sec.gov/rules/final/2016/33-10233.pdf. See Institute [Memorandum No. 30334](#), dated October 21, 2016, for a detailed summary of the liquidity rule and related reporting and disclosure requirements.

^[5] Available at www.sec.gov/comments/s7-03-18/s70318-3129373-161935.pdf and www.sec.gov/comments/s7-03-18/s70318-3129402-161936.pdf. Among other things, the letters (i) requested and provided support for a one-year delay in the liquidity rule’s bucketing and related requirements; and (ii) requested that the SEC ease compliance with the rule’s bucketing requirements, including through targeted amendments (e.g., amending Form N-PORT to eliminate public reporting of bucketing information).

[6] *Investment Company Liquidity Risk Management Programs; Commission Guidance for In-Kind ETFs*, SEC Release No. IC-33010 (Feb. 22, 2018), available at www.sec.gov/rules/interim/2018/ic-33010.pdf. See Institute [Memorandum No. 31106](#), dated February 23, 2018, for a detailed summary of the interim final rule.

[7] Adopting Release at 8-9. The SEC broadly characterizes the concerns as relating to the information's subjectivity; its lack of context; and its potential to highlight one risk (i.e., liquidity risk) over others.

[8] The SEC decided against expanding these splitting provisions beyond what it proposed, noting that "it is necessary to limit split reporting to these [three] circumstances in order to maintain the effectiveness of our monitoring efforts." Adopting Release at 25. However, in response to comments from ICI, the SEC clarified in the Adopting Release that (i) "a fund [is not required] to consistently use a single classification splitting approach for all its positions, as different positions may have different but equally valid circumstances justifying a split classification," and (ii) "funds following the classification splitting approaches delineated on Form N-PORT may apply such splitting more generally in their classification processes under rule 22e-4."

[9] Adopting Release at 27.

[10] The instruction to this item states, "If the board reviews the liquidity risk management program more frequently than annually, a fund may choose to include the discussion of the program's operation and effectiveness over the past year in one of either the fund's annual or semi-annual reports, but does not need to include it in both reports."

[11] These changes are responsive to two recommendations in ICI's comment letter. The SEC did not adopt ICI's third recommended change to this item (exempting "primarily highly liquid funds" and In-Kind ETFs from this requirement). However, the Adopting Release states, "Highly liquid funds or In-Kind ETFs may face fewer, or different, liquidity risks than other funds, and thus the discussion in their shareholder reports may be proportionate or different than for other funds." Adopting Release at 18.

[12] Adopting Release at 18-19.

[13] Adopting Release at 15.

[14] *A Financial System That Creates Economic Opportunities: Asset Management and Insurance*, available at www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-That-Creates-Economic-Opportunities-Asset_Management-Insurance.pdf. With respect to the liquidity rule, the report states that "Treasury rejects any highly prescriptive regulatory approach to liquidity risk management, such as the bucketing requirement. Instead, Treasury supports the SEC adopting a principles-based approach to liquidity risk management rulemaking and any associated bucketing requirements."

[15] ICI and others submitted comments on these questions. ICI's comment letter explained why the advantages to the Treasury's approach would be considerable.

[16] Adopting Release at 30.

[17] Adopting Release at 31. The Adopting Release continues: "We expect that this evaluation will include, at a minimum: (i) the costs and benefits of rule 22e-4 and its

associated classification requirements; (ii) whether there should be public dissemination of fund-specific liquidity classification information; (iii) whether the Commission should propose amendments to rule 22e-4 to move to a more principles-based approach in light of this evaluation; (iv) and whether the Commission should propose to require certain empirical data metrics be disclosed.”

[\[18\]](#) Proposing Release at n.132: “‘Larger entities’ are defined as funds that, together with other investment companies in the same ‘group of related investment companies,’ have net assets of \$1 billion or more as of the end of the most recent fiscal year of the fund. ‘Smaller entities’ are defined as funds that, together with other investment companies in the same group of related investment companies, have net assets of less than \$1 billion as of the end of its most recent fiscal year.”

Copyright © by the Investment Company Institute. All rights reserved. Information may be abridged and therefore incomplete. Communications from the Institute do not constitute, and should not be considered a substitute for, legal advice.