Qualitative Considerations for SEC Rule 22e-4: Looking Past the Numbers to Arrive at a Successful Liquidity Risk Management Protocol Implementation

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Author: Jeffrey Engelberg, CFA

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Focus has been intensifying on rule 22e-4, as the December 2018 first implementation deadline draws closer. Various market stakeholders – including mutual fund managers, data providers, and consultants – have begun to craft solutions towards the implementation of a solution for the obligations created by 22e-4. Our opinion, however, is that virtually all of the focus on a 22e-4 solution has been in addressing the quantitative aspects of the rule, most notably approaching the question of bucketing the fund's positions. Indeed, in some conversations with industry participants and solution providers, we heard comments that 22e-4 compliance solutions must assume prorata liquidation approaches because to require determination of anything more specific to the fund and its manager was impractical. In all, our impression has been that, in a "days to liquidate" calculation, much of the focus has been on the denominator (accessible liquidity per day) of the calculation and the resultant quotient (the days to liquidate). However, little focus has been dedicated to the numerator (how much a specific fund should expect to need to liquidate in a liquidity-risk management assessment).

The purpose of this document and our work are to address this to-date de-emphasized question of the numerator and to fulfill a subset of the obligations set out by rule 22e-4 ("the rule"), adopted by the Securities and Exchange Commission in October 2016. Specifically, the protocol we outline here centers itself on the respective characteristics of each complying manager and fund, towards those entities' complying with 22e-4 by marrying the idiosyncratic state of the manager/ fund with the liquidity available within the market. In combination with a quantitative assessment of the resident market liquidity at the individual security or 22e-4-defined asset class level, we feel that the protocol described herein allows managers and funds to holistically and completely create a robust liquidity risk management program.

The rule instructs on action required by non-exempted, registered, open-end management investment companies. In broad terms, those actions fall into one of five categories:

(a) Completion of a liquidity risk-management program including classification of the investment portfolio based on liquidity;
(b) Establishment of a highly liquid investment minimum;
(c) Monitoring and enforcing a 15% ceiling on illiquid investments;
(d) Procedures governing redemptions in kind; and,
(e) Reporting requirements thereof.

This paper concerns itself with Items a through d enumerated above and assumes complementary policies, procedures, and processes to address reporting requirements will be considered and implemented by funds and their counsel to insure reporting compliance with the rule. Where we recommend action for the fund manager to undertake towards designing a liquidity-risk management program, those parts of this paper are italicized.

The rule requires development of a manager/ fund-specific practical framework for assessment and action to insure funds fulfill their most basic and key characteristic – "redeemability" – defined in this context as a fund's ability to affect redemption requests by fund shareholders within seven days of receipt without adversely affecting remaining shareholders. To remain in compliance then, funds must have plans in place to insure (1) the availability of cash to fund redemptions within seven days, allowing for settlement cycles within the seven-day period; and, (2) a plan of action for a robust residual portfolio for the benefit of the remaining shareholders such that the redeeming act leaves the remaining shareholders no worse off.

To accomplish its intent, the rule leaves accountability for implementation with the investment manager, requiring that the board function in an oversight and review capacity. The resting of responsibility with the fund operator is sensible because, at its core, the rule is a practitioner's one, requiring assessment of the very real-world challenge of accessing liquidity without substantial market impact. Throughout the accompanying release to the rule with the Commission's commentary, reference is continuously made to the real-world aspects of portfolio management (e.g., market conditions, market depth, market impact). These items are best assessed and addressed by the trading community, rather than legal and/or compliance experts. Additionally, the rule demands a degree of independence from the portfolio manager as well:

> However, we are concerned that if only portfolio managers run the program, the program might not be administered with sufficient independence to accomplish the goal of managing the risk of the fund's liquidity. We believe that a fund should generally consider the extent of influence portfolio managers may have on administration of the program, and seek to provide independent voices and administration of the program as a check on any potential conflicts of interest to the extent appropriate….After review of the comments received, we continue to believe that requiring the officer or officers responsible for administering the fund's liquidity risk management program not to be solely portfolio managers strikes the appropriate balance between independence and expertise.[1]

Further, given the breadth of considerations the Commission's commentary on the rule requires – redemption history, market liquidity, stressed conditions, post-trade and settlement timeframes, highly liquid investment minimums, portfolio alteration for redemptions, in-kind redemption procedures – a cross-departmental team with wide-ranging expertise is most appropriate to create a robust liquidity-risk-management program and compliance with the rule. In a summary statement of the obvious - acquiring, managing, and returning assets to fund shareholders is the core of the fund operating model. That much of the investment manager's departmental expertise is required to implement a program assessing and affecting that core of the fund operating model should be expected.

In commentary that some would interpret as existential, the Commission requires funds that have, to date, existed in a manner that potentially would not have been considered in compliance with the rule's requirements to reconsider whether the fund should continue to exist in a 40-act context: "…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…"[2]

From these comments, the Commission seems clear that the onus on the topic of liquidity will have very much shifted on to the funds, and, more specifically, on to the funds' investment advisers as of the implementation date of the rule: "We continue to believe…that the program requirement will produce significant investor protection benefits, in light of the fact that funds are not currently subject to specific requirements under the federal securities laws or Commission rules obliging them to manage liquidity risk."[3] Proving out the ability to respond to redemptions without duress, even under stressed market conditions, will be a proactive obligation of fund managers, responsibilities that the Commission's commentary shows it takes seriously:

> Failure by a fund to maintain a sufficiently liquid portfolio or to otherwise manage liquidity risk calls into question the fund's ability to fulfill the representations (explicit or implicit) made in its prospectus regarding its ability to meet its redemption obligations, as well as its status as an open-end fund. Such failure thus potentially exposes the fund, the investment adviser that manages the fund, and the person responsible for the sale of the fund's securities to the possible application of the antifraud provisions of the securities laws referenced above.[4]

Working through the framework/ protocol we articulate in this document, we believe managers will be in a position to draw tangible conclusions about their funds' state of compliance with the rule. For those funds in compliance, we believe the completion of this working document – which itself will rely on the results of quantitative service providers addressing the "denominator" question discussed earlier – will serve as a roadmap to compliance, complete with data that will be useful in fulfilling reporting requirements under the rule. For those funds for which the outcome of this analysis implies non-compliance with the rule, we encourage those managers to return to the existential question discussed above – whether the subject strategy is appropriate in a 40-act context, and/or, if so, whether the fund is appropriate in its current size. Further, via review of the process outlined herein, we believe boards of directors– in concert with their legal counsel – will be able to satisfy their oversight obligations. As a final introductory note, we remind funds that central responsibility for this program cannot be delegated to a third-party. Accordingly, engagement by fund staff on the final decisions for and overall comfort with this program is vital:

> The Commission recognizes that, in certain circumstances, a fund's service providers might assist a fund and its investment adviser by providing information relevant to a fund's assessing and managing liquidity risk. We note, however, that the primary parties responsible for a fund's liquidity risk management are the fund itself and any parties to whom the fund has delegated responsibility for administering the fund's liquidity risk management program.[5]

Philosophical Approach

The ability of funds to satisfy redemption requests is at the core of the rule. Therefore, the ultimate litmus test for successful compliance with the rule – in a very practical sense – is the fund's manifest ability to meet redemption requests when/ should they occur, while adequately satisfying remaining investors' concerns regarding their being disadvantaged on a fund go-forward basis because of the state of the remaining portfolio. Conclusions from this litmus test, however, can only be observed in something ranging from real time to hindsight, especially for unannounced substantial redemptions which are (definitionally) unexpected events. Nonetheless, the rule requires assessment of circumstances the manager considers remote:

> …we continue to believe that it is appropriate to require funds to consider reasonably foreseeable stressed conditions as part of the liquidity risk *assessment* and *management* requirements [sic]. We believe that funds' liquidity risk assessment should inform the extent to which funds are prepared to manage their liquidity under both normal and reasonably foreseeable stressed conditions – particularly because, for many asset classes, liquidity is adversely affected by market stress and funds need to have a liquidity risk management program that is resilient under all market conditions. Thus, as discussed throughout this Release, a fund must establish liquidity risk management policies and procedures appropriate in light of both normal and reasonably foreseeable stressed market conditions.[6]

In implementing rule 22e-4, the Commission is clarifying its expectation that funds and their managers be prepared to satisfy redemptions and mollify remaining investors under virtually all conditions. If such were not the case, the exigencies of extraordinary redemption situations would be dismissed as events so unlikely that the inability to satisfy redemptions or create a remaining robust portfolio would be excused. Such is not the case in this rule release. Funds and their managers should be conservative in their assessments and implementation of the rule such that the probability of realized non-compliance with the rule's ultimate goals (i.e., gating redemptions or an unacceptable portfolio) is reduced to something approaching zero. We do not believe the one in 500-year storm will be an acceptable excuse on a post mortem regulatory analysis. We therefore aim to introduce significant conservatism into our approach and suggest participating managers not simply waive off questions within this exercise as that-will-never-happen hypotheticals. As is always the case, the worst situations are always the unexpected ones, in which progression past a tipping point creates a snowball-down-the-hill effect. The purpose of this rule and the required considerations is to consider this scenario and plan to buttress against it. We believe funds and their managers are absorbing substantial risk, were they to attempt too much (false) precision in their redemption predictions or only rely on historical redemption trends (especially if the manager has not suffered significant trailing-relative or absolute-negative performance).

As a second matter, our view is funds and their managers must conform to the rule within their historical operating track record and those track records of comparable funds and managers available to them from a foreseeability perspective.[7] However, managers must also assess their trading habits from their own historical inclinations. Managers who historically tend to trade portfolio positions in whole must assess the disposition of whole positions; those who liquidate in substantial pieces must look at partial block executions; finally, those who undertake much slower implementations cannot rely on the unchartered waters of execution immediacy. All the operational characteristics of the fund/ manager operating under normal conditions—including their view of securities as either a function of their idiosyncratic risks/stories or the incremental effect of their quantitative characteristics on portfolio-level targets and their normal pace of trading aggressiveness—inform the categorization of the liquidity profile of each position within the portfolio (and each asset class, for that matter) and influence the manager-specific feasibility of predicted responses to redemptions (i.e., security-specific, pro-rata, or other trading actions):

> We believe that if a fund reasonably anticipates trading sizeable portions of its portfolio positions, the fund's portfolio liquidity could be adversely affected by a lack of market depth for its portfolio investments. A fund could reasonably anticipate trading sizeable portions of its portfolio positions if it often trades relatively large portions of its portfolio positions. Likewise, a fund may not trade larger portions of its portfolio positions on a regular basis, but, could reasonably anticipate, based on past flow patterns or current market conditions that it could encounter larger-than-typical redemptions that would necessitate larger portfolio trades. In both of these examples, such a fund could conclude that it may be difficult to find trading partners for a particular portfolio investment, or may be difficult to sell the investment within a particular time frame without this sale causing a significant value impact….For example, it may be appropriate for a fund with a highly liquid portfolio, with very stable and minimal cash flow projections and significant cash holdings and operating in very stable market conditions, to adopt policies and procedures that consider whether trading relatively small fractions of each of the fund's portfolio holdings would result in significant liquidity impacts. On the other hand, we would generally consider it appropriate for a fund whose holdings are relative illiquid and/ or fairly concentrated, with unpredictable cash flow projections or deteriorating market conditions in the market in which it invests, to consider whether trading larger portions of its portfolio holdings would result in significant liquidity impacts.[8]

In all, *even prior to the rule*, funds, their board, and their managers should recognize, based on the aggregate history of funds, that the probability of being in a circumstance where liquidity actually created a fund impairment was relatively low. The Commission has, nonetheless, finalized a rule, motivated by this liquidity concern, calling for a liquidity-risk-management plan (and reporting) addressing all of the summary items noted above. Funds, boards, and managers should recalibrate themselves into the "small probability" world in which conditions manifest that create liquidity challenges and work to mitigate liquidity-risk concerns within that "fat tail" portion of the normal distribution of liquidity occurrences.

Our protocol begins with a wide lens, assessing more qualitative questions around the fund's reason for existing in its current fund form, and how it considers potential investments for inclusion in the portfolio (and the ramifications of that process on selecting positions to liquidate, when required for liquidity). These are aspects that define the realm in which the fund operates that its managers control. We then consider the shareholder base, including redemption patterns. Shareholders are partners to the fund and its managers, especially in a liquidity context, because shareholders control the fund's need for tangible liquidity. We then narrow the scope to consider the fund – shareholder interaction during requests for liquidity. Within that interaction, first, we consider how the fund might simultaneously satisfy redemption requests but retain its ability to liquidate in a manner least likely to create market impact (and impact remaining shareholders). Bridge financing – and overall, the use of borrowing lines – potentially mitigate this possibility. Second, we investigate under what circumstances in-kind distributions would be appropriate. With this more qualitative backdrop complete, our protocol next assists in creating a process and methodology for categorizing the fund's investments into the four liquidity categories as mandated by the rule. Our protocol then outlines a process by which to determine the fund's needed highly liquid investment minimum and to assess its illiquidity ceiling. For funds making use of derivatives, especially given implications of those trades on liquidity via the obligation to post collateral, our protocol instructs on the Commission's comments regarding reporting the aggregate collateralization of highly liquid securities. Finally, our protocol concludes this exercise with a fund's operational implementation plan for all of the items discussed in this working document/ protocol. Taken together, we believe a fund will have created a well-researched, liquidity risk-management program which considers those aspects outlined by the Commission but also those factors that are fund specific. In defining compliance with the rule, the Commission is quick to highlight that funds must go well beyond a check-the-box approach to this inherently pragmatic aspect of fund operations. Not only must the fund comply with the Commission's rule and comments to be in compliance with the rule, it must also "live" in a practical world given its situation, its history, and the history of its peers: "The liquidity risk assessment requirement generally provides a broad, principles-based foundational framework for a fund's liquidity risk management program…"[9]

Part 1: Suitability of Investment Strategy and Portfolio Concentration for Continued Existence as an Open-Ended Mutual Fund

In no less than five instances in the first 100 pages of the Commission's commentary accompanying the rule, the Commission engages the existential questions for funds and their managers as to whether a given fund's strategy is appropriate for continued existence as an open-ended mutual fund.[10]

The Commission first draws the contrast among open-ended funds and Exchange Traded Funds (ETFs)—the subjects of the rule—and private funds and closed end funds. Whereas, to date, some funds and ETFs have pursued similar strategies to private and closed end funds, the Commission notes that non-focal, closed-end funds and private funds "…invest in portfolio assets that are relatively illiquid without generating the same degree of redemption risk for the fund because investor redemption rights are limited…differ[ing] from redemption expectations of typical investors in open-end funds."[11]

As a first matter then towards completion of a liquidity-risk-management plan, our protocol suggests investment managers should articulate why – across the available fund formats of (1) open-ended funds/non-exempt ETFs, (2) closed-ended funds, (3) private funds, (4) exempted ETFs, or (5) separately managed accounts –the open-ended, non-exempt ETF is appropriate for its investment strategy and in the best interest of subscribing shareholders. Key topics to consider are the pros and cons of each available vehicle relative to the investment strategy; the qualitative liquidity requirements of the strategy (which are best expressed as commentary on the amount of time over which investment theses develop); the types of products used to accomplish the investment strategy and the complexity of those products; the target audience of investors; and, the approachability/ suitability of the investment strategy to that target audience of investors.

At a more granular level, of all the characteristics that could be highlighted in addressing suitability as an open-ended fund, the Commission's commentary[12] makes multiple mentions of the degree of concentration that the fund's portfolio normally exhibits as an attribute that might substantially affect how appropriate a strategy is for open-ended, mutual fund investment. Concerns over concentration[13] seem to center, mostly, on (a) portfolio manager flexibility/timing of sale – that, (with a diversified portfolio) if called upon to covert to cash immediately because of redemptions, a portfolio manager may select those securities whose markets are most favorable for sales; (b) market impact – that the need to liquidate a significant portion of a single security holding would have a greater market impact from the sale than would occur from the sale of a more diversified basket of securities. This market impact has implications for the redeeming shareholder, remaining shareholder, and, potentially, the market as a whole;[14] and (c) liquidity itself/ consistency of liquidity availability – when the portfolio maintains a lower number of holdings, the importance that each position continuously have a liquid market in which to transact becomes much more salient than would be the case in a more diversified portfolio. The Commission's commentary cites:

> … a conceptual relationship between liquidity and sales price in the definition of "liquidity risk" is appropriate…the risk that a fund will not be able to meet redemption requests under any circumstances, as well as the risk a fund could meet redemption requests, but only in a manner that adversely affects the fund's non-redeeming shareholders through significant dilution.[15]

Accordingly, the Commission requires funds and managers to consider the nexus of strategy and liquidity in both normal and stressed conditions: "Thus, if a fund's portfolio strategy involves investing in securities whose liquidity is likely to decline in stressed conditions, a fund should take this into account in determining how its portfolio liquidity could contribute to its overall liquidity risk."[16] The Commission expects that, in certain cases, while a fund will remain in compliance with the 15% ceiling on securities falling into the illiquid bucket of the categorization framework under the rule, it might fail under the rule in juxtaposing its qualitative assessment of investment strategy, concentration, liquidity, and the potential for stressed market conditions:

> …this requirement will likely cause funds to evaluate the suitability of the investment strategies that will be permitted under the 15%

> illiquid investment requirement, but still could entail significant liquidity risk – such as strategies involving highly concentrated portfolios, or strategies involving investment in portfolio investments that are so sensitive to stressed conditions that funds may not be able to find purchasers for those investments during stressed periods.[17]

As a second matter towards the completion of a liquidity-risk-management plan, our protocol suggests investment managers should consider the concentration of their portfolios relative to the spectrum of market conditions the manager could reasonably foresee developing for the typical securities the portfolio maintains, including stressed market circumstances. The manager should consider each asset class of securities typically resident in the portfolio and comment on historical liquidity patterns across a variety of experienced market shocks. While not analyzing each specific security (at this point in the analysis), the manager should holistically comment on whether the asset class(es) has (have) the potential to become illiquid to the point that, relative to the concentration of the portfolio and the absolute level of assets, reasonable progress cannot be made – through normal market trading efforts – to make sales in the portfolio to address redemption needs without substantial market impact. Irrespective of being in compliance with the 15% illiquid categorization requirement, the manager should also comment on the extent to which he/she feels – using his/her experience and expertise – that, qualitatively speaking, each archetypal portfolio has the ability to satisfy redemption liquidity, as it may arise, without affecting remaining shareholders. This last consideration is something of a declaration and is, perhaps, the crux of the liquidity-risk-management plan.

Part 2: Determination of Attractiveness of Securities for Portfolio Inclusion and Appropriateness of Asset Class Determinations

Next, our protocol suggests the fund manager discuss the primary motivations for inclusion of securities/ positions into the portfolio. Namely, the manager should discuss whether positions are selected on an idiosyncratic basis – implying that the qualitative and quantitative characteristics of the singular position are the primary motivating factor and, as such, liquidation of a selected position only for liquidity demands disadvantages the remaining shareholders – or whether the securities are selected based on their more objective characteristics and the incremental effects/ contributions of those characteristics on the portfolio profile at the aggregate level. This latter motivation would indicate that a singular position is less likely to disadvantage remaining shareholders, if liquidated in whole, as long as the aggregate portfolio profile before and after sale is reasonably constant.

Many managers will find themselves in between the two extremes we note above. Of course, such a circumstance should be expected. However, the crux of the issue is seeking to insure – if a singular position is highlighted for sale, purely motivated by liquidity demands – remaining shareholders do not lose out on the bargain of the manager's expertise and security selection (if only, as the Commission comments above, for the duration of a portfolio's rebalancing). Managers must make a judgment call as to whether security-specific or holistic-aggregate-portfolio characteristics primarily guide their styles. This determination will guide the manager in the "approach to liquidations" section of our protocol.

As a related determination, our protocol suggests managers declare whether they will seek to assess position/ security-specific liquidity on the basis of "asset class" or on a security-specific (i.e., line-item-by-line-item) basis. If a manager is more interested in the portfolio at the holistic level, not only should the security/ position-specific idiosyncrasies be less relevant to the manager in making a liquidation determination, but the security/ positon-specific liquidity characteristics should be aggregated as well. On the other hand, if the manager is a more "bottoms-up" investment manager, position/ security-specific liquidity is relevant on a per-position/ security basis. For those funds and managers choosing to aggregate liquidity assessments on an asset-class basis, care should be taken to insure compliance with the Commission's guidance on asset-class aggregation:

- The Commission does not allow "very general asset class categories (e.g., 'equities,' 'fixed income,' and 'other');"[18]
- Funds adopting this "asset class" categorization process must have documented policies and procedures in place to identify exceptions to this process, including exceptions on a security-by-security basis (i.e., if the characteristics of the security make its liquidity unique for classification purposes)[19] and exceptions across time (i.e., if a security is initially qualified to be aggregated into an "asset class" but, at a point in time, has occurrences which make it too unique to remain in the class).[20]

Part 3: Expected Approach to Required Portfolio Liquidations

The Commission does not comment explicitly/ provide guidance on an approach to liquidations. However, implicitly, when considering a sale/ closing transaction motivated by the need for liquidity and when juxtaposing that motivation against a need to insure that remaining shareholders are fairly treated, a fund manager should logically consider the motivations for purchasing securities/ positions into a portfolio for guidance on which securities/ positions should be closed when liquidity demands action but when that action must be equitable to those shareholders remaining. The Commission does comment on actions it would consider unfair:

> A fund that chooses to sell its most liquid assets to meet fund redemptions may minimize the effect of the redemptions on short-term fund performance for redeeming and remaining shareholder, but may leave remaining shareholders in a potentially less liquid and riskier fund until the fund adjusts the portfolio.[21]

As such, funds and managers would be most prudent to incorporate their approach to liquidity-motivated sales (which would either be sales to directly create cash to satisfy redemptions or sales to satisfy the minimum highly liquid investment threshold) into their liquid risk-management plans. Were the implementation not defined, managers and funds risk potentially being seen as cherry-picking or doing what is situationally easiest, irrespective of the implications on remaining shareholders. While managers might be making the correct dispassionate decision in the best interest of redeemability and remaining shareholders, they remain open to 20/20 hindsight questions, if a stated process is not documented and in place. For clarity, the manager is only delineating the process to be followed when liquidity mandates a position sale/ closure. This approach is not applicable when position closure or security sales are driven by normal operating conditions and decisions.

Our protocol next suggests documenting the fund and manager's process for assessing and implementing liquidity-driven position sales/ closures. We believe a pro-rata sale of all securities in the portfolio ensures the portfolio prior to redemption and the portfolio post-redemption are synonymous. If liquidity conditions exist in the market such that a pro-rata sale is feasible (even if the sale requires the use of borrowing over the settlement cycle as discussed in a later section), such a course is the least contestable and most equitable to redeeming and remaining shareholders. If such conditions do not exist, if the fund and manager have a more portfolio-holistic, portfolio-management process, we believe a high-quality directive would be to select a basket of securities/positions to sell/ close, to ensure the salient portfolio characteristics within the portfolio are (nearly) constant pre- and post-position closure/security sale, and to document as much. Of note, the liquidity characteristics of the portfolio before and after trading should be documented to ensure the liquidity profile is constant. If such conditions do not exist and the fund and manager fit into the "bottoms up" category of security selection (in which each security is considered on its own merits), we suggest defining a selection methodology for which securities/ positions will be prioritized for sale/ closure. Of note, we would caution against the liquidity/ease of sale being a driving factor. More probably (and most suitably), the manager should maintain some list that prioritizes the securities/positions in order of attractiveness, given the manager's primary selection/ investment methodology. Closing/selling those positions at the "bottom of the list" (being least attractive as investments, relative to other positions/ securities in the portfolio) would seem most appropriate, as those securities are nearest to being a sale on their own merits outside of the need for redemption liquidity, provided the residual portfolio's liquidity profile is not worsened. In that sense, the portfolio would be strengthened from the sale, and remaining shareholders would be better off, or as well off as if the redemption had not occurred. The manager would certainly not be required to sell/ close the entirety of its least attractive holding, in line with the Commission's comment on selecting those securities that have the most favorable markets. However, the manager should be able to appropriately justify why the basket of securities/ positions to be sold/ closed are in the lower echelon of attractiveness to retain. Beyond stating which of these methodologies the manager will pursue as needed, the selection criteria itself should be documented, as well as the frequency with which the sale prioritization (if not pro rata) will be updated. Upon updates, in practice, should the manager find its liquidation priority/ methodology conflicts with its belief of the market liquidity accessible in these securities/positons on an "as needed" basis, the manager should consider increasing its highly liquid investment minimum to account for this situation- specific lower liquidity of the sale portfolio. This process and analysis should also be documented.

Part 4: Overview of Historical Redemption Patterns and Fund Shareholder Base

Fund shareholders drive redemptions. Taken to its logical and unrealistic extreme, if no fund shareholder ever submitted a redemption request, the fund would have no need for a liquidity risk-management plan. However, irrespective of performance, funds and their managers must operate under an understanding that redemptions will occur, that those redemptions might be unpredictable, and, that the fund's circumstance may affect experienced redemptions:

> These factors in fund redemptions – either individually or in combination – can create incentives in times of liquidity stress in the markets for shareholder to redeem quickly to avoid further losses (or a "first-mover advantage"). If shareholder redemptions are motivated by this first-mover advantage, they can lead to increasing outflows, and as the level of outflows from a fund increases, the incentive for remaining shareholders to redeem may also increase. Additionally, a fund experiencing large outflows as a result of redemptions may be exposed to predatory trading activity in the securities it holds…there can be significant adverse consequences to remaining investors in a fund when it fails to adequately manage liquidity.[22]

This concept of "negative gamma" in shareholder redemptions is akin to the fear and mania of crowds, and, is very much unpredictable and punitive when it occurs. Funds exist within the market ecosystem; many of whose motivations are exogenous and out of the fund's control. Good performance cannot be viewed as a ticket away from redemption risk with impunity:

> Predictability about whether periods of market stress or declines in fund performance generally lead to increased redemptions of fund shares is particularly significant…. To the extent a fund understands the composition of its shareholder base…, it may be able to better predict fund flows in response to market events or fund performance.[23]

Accordingly, the Commission advises funds that an analysis of its partners in investment – the fund's shareholders – need to be undertaken, as does an analysis of the fund's redemption policies and procedures. Managers need to consider these analyses both in normal and stressed market circumstances.

Our protocol, then, recommends consideration of the historical redemption patterns of the fund, the composition of the shareholder base (including the concentration of the shareholder base); the disposition of those shareholders to redemption (the character/ nature of the fund's investors); the distribution channels the fund relies upon; and, generally, the fund's confidence of its assessment thereof. Additionally, the Commission requires the fund not only to consider its own experience in all of these aspects but to consider those of comparable funds to the extent possible (where comparable could span the experiences of other funds in the fund's family or the experiences of funds operating with similar investment strategies). The analysis should document the fund's efforts at market research to assess comparable funds' experiences. To the extent stressed market conditions or stressed conditions for the fund or its comparables are identifiable (due to market turbulence, stress within the fund's investment strategy, fund-specific underperformance, or the underperformance of specific comparables), those instances should be highlighted whereby the fund can prognosticate about the redemption character of its fund on a go-forward basis, both in normal and stressed conditions.

Finally, in a companion analysis, the fund manager should discuss the fund's stated redemption policy and should highlight whether, in practice, the fund has created a reputation/ history for fulfilling redemption requests in less time. This history is important both in satisfying the expectations of shareholders, and, perhaps more importantly, in assessing the redemption cycle within this shorter timeframe. As discussed earlier, the first-mover problem (shareholders redeeming because they perceive the possibility that others will redeem) can snowball from the fund extending its redemption cycle, even if that revised cycle still complies with the statute. This aspect of the analysis should also discuss whether the fund will continue this precedent going forward, especially in light of its need to be in compliance with this rule and a formal liquidity risk-management program. To the extent it will revert from its operational precedent to its stated redemption timeline, the analysis should discuss how the fund intends to proactively communicate such a practical change to its shareholders and its prospective shareholders.[24]

Part 5: Use of Borrowings and Their Potential to Bridge Redemptions

Redemptions (barring in-kind redemptions) require cash or a viable avenue to acquire cash to deliver against redemption requests. For fund positions whose settlement cycles create settled cash into the fund within the shareholder-redemption settlement cycle, no bridge is needed to transform fund positions into cash. However, funds may maintain positions which are able to be traded reasonably quickly but whose settlement cycle extends beyond the statutory timeframe to settle fund-shareholder redemption requests. In these cases, leverage/ borrowing lines may bridge a redemption challenge while not levering fund returns.

Employed when needed without any offsetting action, borrowings lever the returns of those remaining shareholders. As such, leverage employed for redemption's sake – where the subsequent performance experience of the portfolio is negative – could be cited as a violation of the Commission's redeemability definition, namely leaving remaining shareholders worse off: "We have concerns that, in some situations, borrowing arrangements may not be beneficial to a fund's liquidity risk management to the extent that the fund's use of borrowings to meet redemptions leverages the fund at the expense of non-redeeming investors."[25] On the other hand, leverage is a more innocuous solution, when redemption needs require sales of securities/closure of positions whose settlement timeframe might exceed the redemption one. In this case, leverage is a bridge whereby proceeds from sale/ closure are applied against the temporary leverage balance, as a cash-flow bridge. The Commission is much more supportive of these uses: "Funds may also wish to consider whether to obtain an additional source of financing (for example, a committed line of credit dedicated to that fund) to bridge the period until sales would settle."[26]

The next step of our protocol requests the fund manager cite its regular uses of leverage, if applicable, and its extraordinary non-redemption-motivated circumstances when leverage might be employed. Such documentation may cure the potential liability funds and their managers might incur if a bona-fide use of leverage, unrelated to redemption requests, coincidentally occurs at the same time as redemption requests (opening the door for objections by remaining shareholders under the rule). If the fund regularly employs leverage as an aspect of its investment strategy, that process should be outlined, including high and low leverage ratios above/ below which the fund would take action to return leverage to normal levels. Finally, the commentary for this section *should also outline the fund's access to bridge leverage, which would be used to fund redemption requests while sales of securities/ positions requiring a longer cash-conversion cycle progress.*

Part 6: Circumstances Under Which In-Kind Redemptions Would Occur

In practice, in-kind distributions are typically viewed as a (near) last resort to satisfy redemption requests. In-kind redemptions are more operationally effort intensive than cash redemptions, when they are feasible. Some investors (e.g., retail) or some of the channels through which investors invest (e.g., omnibus accounts) may not be able to accommodate in-kind redemption receipt. Additionally, when in-kind redemptions occur, the fund and its manager must answer the questions of which securities to distribute and the tax consequences thereof, both to the redeeming party and the remaining fund, insuring fairness. Finally, for investors who might be subject to the fund's potential to redeem on an in-kind basis, funds must insure those investors are aware of this eventuality.[27]

The Commission warns of the fund and manager's continuing obligation for fairness when undertaking in-kind distributions:

> We caution that if a fund redeems an investor's interests in a fund by transferring an unrepresentative set of securities to the investor, this may raise questions of shareholder discrimination and unfairness (as well as potentially cherry picking and favoritism), which should be addressed in the fund's policies and procedures.[28]

Accordingly, our protocol requires the fund and its manager to comment on the following matters concerning in-kind distributions:

- *Does the fund have the right to undertake in-kind distributions?*
- *Under what circumstances will the fund satisfy redemption requests via in-kind transfers? Do these circumstances create discretion for the manager to satisfy redemptions in kind or will in-kind transfers always occur under such circumstances?*
- *Has the fund notified investors of the potential that redemption requests might be satisfied via in-kind transfers and the conditions under which the fund might consider satisfying redemptions via in-kind transfers? If so, how has this information been communicated? If not, how will the fund ameliorate this lack of disclosure and on what timetable?*
- *What information does the fund and its manager have on the composition of its shareholder base and its distribution channels as a function of those which can receive in-kind redemption transfers and those which cannot? How stable is the relationship? Overall, what percentage of the archetypal shareholder base – as a percentage of assets under management – can receive in-kind transfers to satisfy redemption requests?*
- *If redemption requests will be satisfied on an in-kind basis, what are the processes and procedures for determination of which securities will be selected for transfer and/or will the fund transfer on a pro-rata basis?*
- *For any transfers which result in odd lot or small lot transfers, are these transfers feasible? If not, how will the fund bridge any redemption gap generated by the inability to transfer these partial lots?*

- *Are illiquid securities candidates for in-kind redemptions? If not, how does the fund believe it is satisfying its fairness requirement to redeeming and remaining shareholders in increasing the weight of illiquid securities in the residual/remaining portfolio?*
- *What safeguards are setup within the manager's in-kind processes and procedures to adequately assess the tax ramifications of in-kind transfers to assure fairness across redeeming and remaining shareholders? Is the manager confident that these assessments can be completed within the compressed timeline of a redemption cycle and/or under the stressed circumstances that will most likely occur in scenarios allowing for in-kind redemptions?*
- *To what extent are the policies and procedures for in-kind transfers distributed across the operational groups of the manager? How confident is the manager that these groups will recognize the circumstances which allow or mandate in-kind redemptions and initiate these processes?*
- *The fund is advised to attach a copy of its processes and procedures for in-kind redemptions.*

Part 7: Analysis of Portfolio Investment Characteristics and Liquidity Categorizations Based on Redeemability Risk

In our view, the classification of portfolio investments into liquidity categories – along with the highly liquid investment minimum, which is the next section of our protocol – forms the crux of the rule. If the ethos of the rule is insuring adequate liquidity for redeeming shareholders while not disadvantaging those that remain, then, understanding the liquidity characteristics of the portfolio and determining the amount of cash to keep on hand to buffer any need to liquidate positions are core for the fund and the manager.

Initial readings of the rule could create alarm amongst mutual fund managers that very few funds are viable under the rule because, at some level of assets under management (i.e., for a large enough fund), even a well-diversified fund could not justify stating its positions were able to be liquidated within seven calendar days without significantly affecting the market value of those positions, thus conceding the entire portfolio were illiquid and in non-compliance with the rule. The Commission allays these concerns by clarifying through its commentary that funds should not take a complete liquidation scenario as a starting point for position classification: "We noted that, although we agreed that a fund not being able to convert its entire position in an asset to cash at a price that does not materially affect the value of that asset should not, by itself, be dispositive of a portfolio asset's liquidity…"[29]

Triangulating the size of the position to consider
While not requiring an entire position be considered in assessing liquidity risk, the Commission is quick to negatively comment on a fairly widely adopted practice to date - using the ability to sell a single trading lot as justification that a position is liquid. Rather, the Commission adopts a market depth approach to liquidity risk, categorization of positions, and the 15% illiquidity boundary (to be discussed):

> …we believe that the market depth considerations required by the final classification requirement will appropriately require a fund to consider situations in which the size of a fund's holdings could significantly affect those holdings' liquidity and impact the fund's

> ability to manage its liquidity risk – that is, when the portfolio liquidity may be significantly constrained by the fund's ability to trade meaningful sizes of its portfolio holdings. We believe this assessment of market depth will assist in illiquidity determinations incorporating a realistic analysis of a fund's ability to meet redemption request without significant dilution, and thus in funds better managing liquidity risk.[30]

As to what size of the portfolio the manager should consider for classifying the position, the Commission directs the manager to assess based on:

> …the sizes of a particular investment that the fund would reasonably anticipate trading and whether trading in such sizes could significantly affect the investment's liquidity. If so, the fund would be required to take this into account in classifying the liquidity of that portfolio investment. If the fund determined, after conducting the required market depth analysis, that a downward adjustment in the liquidity classification of a particular investment is appropriate, the new liquidity classification that the fund assigns to this investment would apply to the entirety of the fund's position in that investment (not, as proposed, to portions of that position).[31]

The Commission leaves each fund in a situation whereby it is tasked under the liquidity-risk management program with (1) making a determination of potential redemption requests under normal and stressed conditions; (2) assessing how the fund and its manager will take action on these requests, if necessary, by market action; (3) given the first two determinations made, translating actions required effectively into hypothetical position-level (or asset-class) trading orders; and, finally, (4) assessing the liquidity of its positions based on those expected orders.

As such, our protocol calls for the participants in the fund's liquidity-risk management program—based on data, perspective, judgment and expertise documented in the work completed within the protocol to this point—(1) to document its assessment of worst-case foreseeable redemption requests; (2) given its determination of how the fund would respond to such requests where the redemptions would require market actions (e.g., position-specific sales, pro-rata portfolio liquidation, etc.), to translate that hypothetical request into a set of trading orders for the fund; (3) based on the size of those orders, to assess the ability of the fund to affect those transactions, limited by a need to not significantly affect the market value of those positions, and primarily to determine how many calendar days would be required to trade those sale/closure orders (for those funds that have adopted an asset-class approach, these determinations would be made on an asset-class basis, provided processes are in place to identify exceptions to the classes); and, (4) to consider the settlement cycle of those transactions. Based on the days required to transact, the fund should classify each position or class as highly liquid, moderately liquid, less liquid, or illiquid.

Assessing days to transact

The Commission has adopted a market depth approach to market liquidity determinations. While – in a departure from the proposed rule – the final rule does not require assessment across the nine factors outlined in the proposed draft,[32] we believe funds and their managers would be best served integrating into their analyses of market depth liquidity the factors outlined in the commentary.[33] Of course, the Commission encourages plan writers to incorporate any other factors they feel appropriate.[34]

The Commission also encourages assessment to be made with both historical data and forward-looking thoughts on how market conditions and market depth may change in the future: "…we believe analyzing past data, while considering how that data may change in the future is an inherent aspect of all risk management and does not render such analysis fruitless."[35] Further, the commentary calls for market depth to be considered under both normal and stressed market conditions. As a mitigating factor for firms with highly successful trading desks, the Commission explicitly allows for past success – over and above expected market depth in the generic case - to be brought into the analysis:

> We also recognize that there could be situations in which the requirement to consider entire position size in classifying a fund's portfolio investments, regardless of the size of trades a fund typically engages in, could make a fund appear to be less liquid than the fund's actual trading experiences in light of its portfolio investments' market depth. This could be misleading if the fund were actually able to trade a large percentage of its holdings fairly quickly without the fund's trades significantly moving the investments' prices.[36]

For funds and managers wishing to claim extraordinary trading acumen relative to a generic market depth analysis, we recommend an addendum to protocol documentation within this section where the manager documents – via transaction cost analysis reports that show actual market impact versus pre-trade market estimates over constrained periods of time – such skill.

Classification definitions

- Highly liquid: convertible into cash within three business days without a significant change to market value;
- Moderately liquid: convertible into cash in more than three calendar days but less than seven without a significant change to market value;
- Less Liquid: can reasonably be expected to be disposed of (not including settlement) within seven calendar days without a significant change to market value with settlement expected out more than seven calendar days; and,
- Illiquid: cannot reasonably be expected to be disposed of (not including settlement) within seven calendar days without a significant change to market value.[37]

Part 8: Determination of the Highly Liquid Investment Minimum

Consideration of the highly liquid investment minimum is meant to occur simultaneous to consideration of the categorization of positions (or asset classes) within the portfolio. The amount of highly liquid assets informs the fund's expectations as to its potential need to trade less liquid assets (in the generic sense of the term – assets classified as being anything other than highly liquid). Similarly, the fund's assessment of the liquidity of its portfolio positions informs the highly liquid investment minimum whose primary intent is "to increase the likelihood that a fund would hold adequate liquid assets to meet redemption requests without materially affecting NAV"[38] and "to help manage the fund through stressed conditions or opportunistically readjust the portfolio."[39]

Funds are required to consider normal and stressed market conditions in determining their minimum[40] and to consider all factors already considered in determining liquidity categories. Overall, the Commission expects industry data will aggregate to produce some sort of baseline for a highly liquid investment minimum.[41] Presumably such baselines will be delineated by strategy, asset class, etc. Accordingly, we recommend funds and their managers insure they are adequately gathering and considering comparable funds during their assessments (as already noted above).

Additionally, lower liquidity and greater volatility in shareholder subscriptions and redemptions, and the use of borrowings and derivatives are all factors the Commission cites as reasons to encourage setting a higher minimum.[42] However, as a mitigating factor to their consideration – and a change from language originally proposed – funds and their managers need only consider foreseeably stressed conditions between the then-current time of assessment and the next assessment,[43] a period which is limited to a maximum of one year.

Finally, funds are required to maintain records of the process by which they determine their minimum and must maintain policies and procedures for reporting and curing highly liquid assets falling below the minimum level (of note, funds must only consider their assets in determination of compliance with the minimum).[44] Critical aspects of these policies and procedures are:

- Reporting to the board at each regular meeting any broach of the highly liquid investment minimum;
- Reporting to the board and the Commission (via a non-public filing) within one business day if any shortfall of highly liquid assets (relative to the minimum) lasts beyond seven calendar days;
- While the highly liquid investment minimum is normally determined by the fund and its manager without board direction, if the fund is in non-compliance with its minimum, changes to the minimum require board approval;
- A discussion of the minimum must be included in the annual report to the board regarding the efficacy of the liquidity risk-management program;
- While not required, a fund may wish to cite circumstances under which it would review the highly liquid investment minimum more frequently than the annual requirement; and
- While not required, a fund may wish to discuss various scenarios whereby the fund might find itself out of compliance with the minimum and the steps it might take or prohibitions it might temporarily implement in such cases.[45]

Our protocol next requires the fund to overview how it arrived at its highly liquid investment minimum, including what considerations it gave to stressed market conditions. The fund should also state the policies and procedures it is adopting around required Board reporting on this matter and any other optional governors on the highly liquid investment minimum it is choosing to undertake. The fund should also discuss its investment strategy and its operational status towards rationalizing whether it will assess the highly liquid investment minimum only annually, or, whether it believes such assessments need occur more regularly (and what that schedule will be).

Given the similarity of analysis required between this section of the liquidity risk-management program protocol and the liquidity categorization already completed, it may be rationale to incorporate work or considerations by reference.

Funds which "primarily"[46] hold highly liquid assets are required to neither determine a highly liquid investment minimum nor adopt accompanying policies and procedures. However, such funds are obligated in their liquidity risk management plans to define <u>primarily</u> and to put in place safeguards to prevent style drift (from a liquidity perspective). If drifted occurred, such funds would then fall under the general highly liquid investment minimum requirements.[47] Funds that might consider their strategies "on the fence" with respect to their characterization of assets are best advised to perform and implement all aspects of the highly liquid investment minimum portion of the rule.[48]

Part 9: Use of Derivatives and Impairment of Highly Liquid Securities for Collateralization Requirements

The use of derivatives by a fund introduces potential challenges within the context of its liquidity risk-management plan. As a first matter, the derivatives themselves need to be classified into one of the four categories outlined within the rule. Secondly, the margin posted against these derivatives, even if the assets underlying those postings are considered highly liquid, is pragmatically impeded by its role as collateral. Finally, derivatives have the potential to require further collateral postings occur.

In its proposed release, the Commission was exceptionally direct in its forming view that the liquidity characteristics of an asset are overshadowed, when it serves as collateral, by the liquidity profile of the derivative to which it is associated: "...because these assets are only available for sale to meet redemptions once the related derivatives position is disposed of or unwound, a fund should classify the liquidity of these segregated assets using the liquidity of the derivative instruments they are covering."[49] The Commission then went on to overview a categorization methodology of assets encumbered as collateral to derivatives. The summary points were as follows:

1. Funds are required to notate the percentage of assets otherwise falling into the highly liquid category that are used to collateralize derivatives falling into categories other than the highly liquid category.
2. Should a fund be able to post assets that fall into a category other than the highly liquid category as collateral against derivatives, in addition to posting highly liquid assets as collateral, the

> fund must assign the highly liquid collateral, first, to all derivatives falling into non-highly liquid categories.[50]

In its final release and rule, the Commission iterates on its approach to derivatives liquidity by requiring that Funds state that amount of their highly liquid assets which, in aggregate, collateralize derivatives which are not themselves considered highly liquid. This directive is a more balanced approach than requiring that otherwise-more-liquid assets which are posted as collateral be denigrated in their liquidity classification to that of the derivative for which they serve as collateral. However, the Commission does mandate (in line with the second point above) that highly liquid collateral be counted ahead of less-liquid collateral towards collateralizing less liquid derivatives, unless less liquid collateral is specifically segregated against certain derivatives[51].

Further, the Commission opens a reasonably conservative view of the obligations of a fund and its managers to provision for "what if" circumstances within a derivative transaction by instructing review of "…the potential liquidity demands that may be imposed on the fund…including any variation or collateral calls the fund may be required to meet."[52] The Commission returns to this concept later in the documents, commenting "…assessing a fund's liquidity risk generally may include an evaluation of the potential liquidity demands that may be imposed on the fund in connection with its use of derivatives, including any variation margin or collateral calls the fund *may be required to meet* (italics added)."[53] We advise funds and their managers to consult counsel on the extent to which compliance with the rule requires a fund to consider extraordinary movements of derivatives and their underlying reference assets. Taken to its extreme, uncovered, short-call positions have theoretically infinite collateral/margin-call potential. Similarly, but more contained by the worst-case potential for asset prices to go only to zero, uncovered put positions have theoretical collateral/ margin-call potential from the underlying reference assets' current values to zero (when we discuss uncovered option positions, we mean those options without an offsetting long option position with a strike which is farther from the money or an underlying cash position which offsets the option position).

The next section of our protocol directs funds and their managers to, first, overview their uses of derivatives. Part 7 of this protocol has already mandated classification of fund derivative positions into one of the four liquidity categories as specified by the rule. Therefore, within this section, managers should document otherwise highly liquid assets that are encumbered because of their serving as current collateral to derivative and document that aggregate percentage of highly liquid assets which are serving as collateral to derivatives which are not highly liquid. If there is any less liquid collateral that is specifically segregated as collateral to derivatives not in the highly liquid category, such specific arrangements should be noted in this section. Finally, we reiterate our directive for fund managers to consult with counsel to understand the degree to which they must incorporate extraordinary moves in the underlyings of derivatives, producing dramatic collateral calls, an act which could further cause otherwise highly liquid assets to be later aggregated as collateral. The fund should state herein its approach to such potentialities.

Part 10: Illiquidity Ceiling

While the illiquid category is embedded in the liquidity categorization exercise above, the Commission aims to further focus on the illiquid category of a fund's portfolio, placing additional obligations on funds who exceed the 15% ceiling:

> While we believe that the highly liquid investment minimum requirement will increase the likelihood that each fund holds adequate liquid assets to meet redemption requests without significant dilution of remaining investors' interests in the fund, the limit on illiquid investments also should increase the likelihood that a fund's portfolio is not concentrated in investments whose liquidity is extremely limited, and thus will serve as an across-the-board limit on fund illiquidity.[54]

As a first matter, the Commission has harmonized the definition of illiquid asset for this 15% rule, in line with its definition of illiquid in the categorization section of the rule. By virtue of that harmony, in assessing this 15% ceiling, funds and their managers must also consider the factors listed in the categorization section, all revolving around market depth, trading, and investment-specific considerations.[55]

Secondly, the rule imposes an acquisition prohibition: Funds may not acquire assets if those assets would be deemed illiquid and if acquisition would broach the 15% ceiling.[56] Such a prohibition leaves circumstances (1) whereby an asset is reclassified after an acquisition as illiquid, or, (2) whereby, if through movements within the portfolio, an illiquid asset (or set of assets) below 15% at acquisition becomes more than 15% of the portfolio. In both cases, while reporting requirements to the board and required board action (in addition to confidential reporting to the Commission) are reasonably onerous and while the Commission imposes a timetable on disposition of illiquid assets to return to compliance with the 15% ceiling, the Commission does not require immediate disposition. Doing so could hurt fund shareholders if illiquid assets are sold under duress, potentially resulting in fire sale prices.[57] Nonetheless, funds that breach the 15% ceiling must take the following immediate corrective action under the rule:

1. Report to the board of directors within one business day, explaining the reason for the breach, the extent of it, and the fund's plan for corrective action within a reasonable timeframe;
2. Report such a breach to the Commission;
3. Should the same breach still be in effect 30 days after its initial occurrence, the board of directors – including a majority of independent directors – must reconsider whether the liquidity risk-management plan currently in force is appropriate and in shareholders' best interests; and
4. Include reference to any breaches to the 15% ceiling in the fund's annual report to the board of directors assessing the efficacy of the liquidity risk-management plan.

Reinforcing its significant focus on insuring funds do not maintain too large a portfolio of illiquid assets, the Commission comments on the burdens that non-compliance with this aspect of the rule will place on boards:

> We expect that this requirement will appropriately focus boards and funds on resolving liquidity impairments in a reasonable period of time in the best interests of the fund and its shareholders. In light of the risks attendant in holding larger proportions of illiquid investments, we believe it is important that the board is provided sufficient information and regular updates so that it can make an informed judgment.[58]

The final phase of our protocol asks funds and their managers to reiterate the fund's current level of illiquid assets; to outline the policies and procedures in place for monitoring the illiquid ceiling; and, to inform the board and the Commission should a breach of the ceiling ever occur. Finally, any prophylactic measures the fund and its manager undertake in attempts to stem a 15% breach before it occurs should be discussed, including policies and procedures.

Conclusion

At an existential level, we believe consideration of this protocol – whether informally or in a formal manner designed to demonstrate regulatory compliance – is healthy for investment managers and funds which offer regular liquidity/ redemption ability to their investors or shareholders. While many of the formal requirements of the forthcoming rule which have motivated this discussion will be of lesser interest to uncovered vehicles, the ability to return capital under whatever terms that capital was accepted ought to be a priority consideration for the managers of that capital. We thus believe many of the aspects and exercises within our protocol are more universally relevant.

With respect to the pending implementation of the SEC Mutual Fund Liquidity Rule (SEC 22e-4), aside from filing requirements and frequency of update and review – on which legal counsel is best suited to consult – we believe the exhibits created in this protocol will substantively complete the insights directed within rule 22e-4 and suggested by the Commission in its accompanying comments. We suggest collating this protocol with its exhibits under a cover letter, submitted by the manager and acknowledged as reviewed and accepted by the board, which states:

1. The manager undertook its responsibility under 22e-4 with a cross-departmental team reflecting all of the expertise of the manager;
2. The manager believes its investment strategy is appropriately distributed and suitable for a mutual-fund audience, especially in light of rule 22e-4 liquidity obligations;
3. The manager expects to be able to accommodate redemption requests – in normal and stressed markets – while preserving the value delivered from its efforts to remaining shareholders;
4. Should the manager elect to satisfy redemptions via in-kind redemptions, those processes and circumstances are appreciated internally and externally (by fund shareholders);
5. The manager has assessed the liquidity characteristics of its portfolio and assigned each investment – by security or asset class – into one of the four categories directed under the rule, given the fund and its manager's expectation of liquidity which can foreseeably be expected to be needed, with the following distribution:
    a. Highly liquid: ____%
    b. Moderately liquid: ____%
    c. Less liquid: ____%

    d. Illiquid: ____%
6. In light of liquidity requirements and the considerations outlined in this working document and set forth by rule 22e-4, the fund and its manager have established a highly liquid investment minimum of ____% with policies and procedures in place to monitor this threshold;
7. The manager has considered its derivative efforts in drawing its liquidity conclusions and has noted those highly liquid investments that serve as collateral of less liquid derivatives; and
8. The fund and its manager understand that a maximum of 15% of the fund can be categorized within the illiquid category without following the notification and corrective protocols as outlined in the rule 22e-4 and that such policies and procedures are in place for monitoring and corrective action, if broached.

With these efforts completed, reviewed with the frequency directed by the rule and in consultation with counsel and providing for any extraordinary interim reconsiderations as circumstances warrant, we believe a fund and its manager will be in compliance with rule 22e-4.

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[1] Securities and Exchange Commission, 17 CFR Parts 210, 270, 274 Release Nos. 33- 10233; IC- 32315; File No. S7-16-15 RIN 3235-AL61, Investment Company Liquidity Risk Management Programs, https://www.sec.gov/rules/final/2016/33-10233.pdf, 252 – 253.
[2] Ibid., 440.
[3] Ibid., 47.
[4] Ibid., 21.
[5] Ibid., 253.
[6] Ibid., 113.
[7] Ibid., 78.
[8] Ibid., 141-143.
[9] Ibid., 43.
[10] Ibid., 36, 55, 66, 71, 75.
[11] Ibid., 36.
[12] Ibid., 55, 66.
[13] Ibid., 71.
[14] Ibid., 34.
[15] Ibid., 59.
[16] Ibid., 75.
[17] Ibid., 69.
[18] Ibid., 137.
[19] Ibid.
[20] Ibid., 133.
[21] Ibid., 28-29.
[22] Ibid., 32-33.
[23] Ibid., 77.
[24] Ibid., 14-15.
[25] Ibid., 85.
[26] Ibid., 132.
[27] Ibid., 239-243.
[28] Ibid., 242.
[29] Ibid., 139.
[30] Ibid., 130.
[31] Ibid., 142.
[32] Ibid., 154-155.
[33] Ibid., 155, 160-174.
[34] Ibid., 159.

[35] Ibid., 158.
[36] Ibid., 141.
[37] Ibid., 438-439.
[38] Ibid., 197.
[39] Ibid., 217.
[40] Ibid., 205.
[41] Ibid., 204.
[42] Ibid., 207-208.
[43] Ibid., 205.
[44] Ibid., 195-196.
[45] Ibid.
[46] Ibid., 224.
[47] Ibid., 225-226.
[48] Ibid.
[49] Ibid., 146.
[50] Ibid., 152.
[51] Ibid., 442.
[52] Ibid., 59.
[53] Ibid., 146.
[54] Ibid., 234.
[55] Ibid., 231-232.
[56] Ibid., 236.
[57] Ibid.
[58] Ibid., 238.