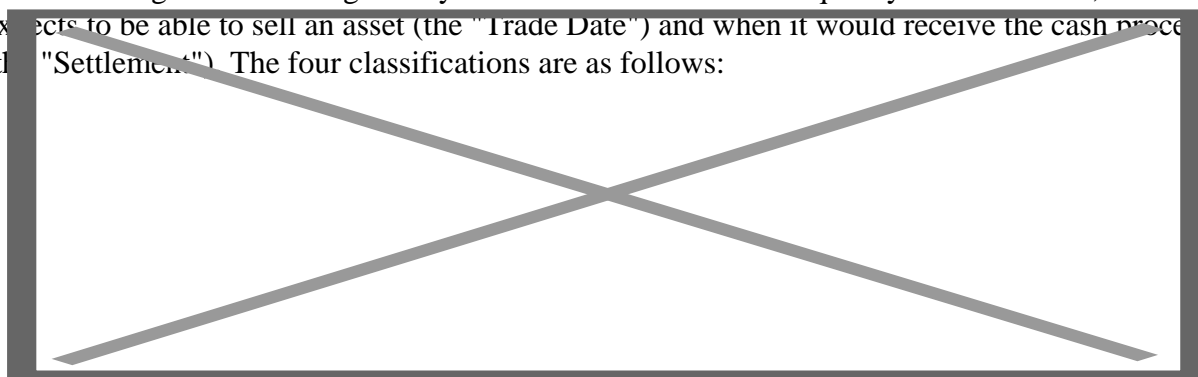


## Navigating Mutual Funds in Rough Markets—Liquidity

During a [recent webinar](#), Steve explained that the market and trading conditions caused by the COVID-19 pandemic might be "reasonably expected to materially affect one or more of [a mutual fund's] investments' classifications" for purposes of the fund's liquidity risk management program (its "LRM Program"). In this circumstance, [Rule 22e-4](#) under the Investment Company Act of 1940 requires more frequent review of these classifications. This post describes how a rough market may require a mutual fund (other than a money market fund or in-kind exchange traded fund) to reclassify an investment's liquidity classification.

### Liquidity Classifications

An LRM Program must assign every investment to one of four liquidity classifications, based on when a fund expects to be able to sell an asset (the "Trade Date") and when it would receive the cash proceeds from the sale (the "Settlement"). The four classifications are as follows:



For example, a

portfolio holding that can be sold on the NYSE today and settled in two business days would be classified as Highly Liquid, while a bond that can be sold over-the-counter today and settled in five business days would be classified as Moderately Liquid.

### "RATS" in the Classification Maze

"Liquidity classification of investments requires consideration of the 'sizes that the fund would reasonably anticipate trading' and market depth." (See Question 19 of the linked [FAQ](#).) The "reasonably anticipated trading size," which goes by the unfortunate acronym "RATS," is the quantity of an investment (or class of investments) the fund would reasonably expect to sell in order to obtain liquidity for redeeming its shares. A fund may anticipate selling an investment over several days if the RATS exceeds the average daily trading volume (or other measure of market depth) of the investment (or of that class of investments). If the expected trading period exceeds three business days, this will normally lead to the investment being classified as something other than "Highly Liquid." Adverse market conditions can lead a fund to reclassify an investment for a couple of reasons. First, trading volumes may contract and reduce market depth. As markets thin out, the number of days required to sell the RATS may increase to such an extent as to require reclassification of the investment. Second, a fund typically determines its RATS based on the largest amount of net redemptions expected during stress conditions. If a fund begins to experience unprecedented net redemptions, it may need to increase the RATS for its investments. Growing RATS when market depth is shrinking can lead to reclassification of an investment (or class of investments). If a third-party service provider's system or a sub-adviser reclassifies an investment, the fund has up to three business days in which to verify the reclassification. (See Question 32 of the [FAQ](#)).

# Impact of Reclassifications

Unless a fund holds primarily Highly Liquid Investments, the LRM Program must set a Highly Liquid Investment Minimum ("HLIM") as a percentage of its assets. Reclassifications of investments below Highly Liquid, combined with portfolio sales, changes in the relative value of investments and net redemptions, can cause a fund to fall below its HLIM. If the fund remains below its HLIM for seven consecutive days, it must:

- File a non-public report on Form N-LIQUID with the SEC, and
- Report the shortfall to the fund's board of directors (the "Board") and provide a plan to restore the minimum in a reasonable time.

Mutual funds also cannot hold more than 15% of their assets in Illiquid Investments. Reclassifications of investments as Illiquid Investments, combined with portfolio sales, changes in the relative value of investments and net redemptions, can cause a fund to exceed the 15% limit, in which case it must:

- File a non-public report on Form N-LIQUID with the SEC, and
- Report the event to the Board and provide a plan to reduce Illiquid Investments below 15% in a reasonable time.

If the fund's Illiquid Investments are still above 15% after 30 days, the Board, including the independent directors, must assess whether the plan continues to be in the best interest of the fund.

## Conclusion

There is more to an LRM Program than liquidity classification, particularly the all-important goal of meeting redemptions. Nevertheless, a fund should not overlook the need to monitor its liquidity classifications in these turbulent times. My next post will address the relationship of liquidity classification and the valuation of investments.

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