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Significant SEC Rulemaking to Address Liquidity of Mutual Fund Portfolios

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On September 22, 2015, a unanimous US Securities and Exchange Commission proposed far-reaching rule reforms intended to address liquidity risks in the mutual fund industry. The agency's preamble indicates it was prompted by a number of factors: increasing complexity of fund portfolios, the continued rise of mutual funds and ETFs as vehicles for retail participation in the markets and the simple passage of time since the SEC last addressed these topics.

Core elements of the package are:

- **Mandated liquidity risk management programs.** Every mutual fund and open-end ETF (except for money market funds and unit investment trusts) would implement a formal liquidity risk management program. The program would center around:
 - **A three-day liquidity band** under which every fund will select and maintain a fund-specific "three-day liquid asset minimum," plus
 - **Publicly reported position-level liquidity classifications.**
- **Optional "swing pricing."** Mutual funds (but not money market funds or ETFs) would have the option of establishing swing pricing – a process for adjusting a fund's net asset value to pass on to purchasing or redeeming shareholders more of the costs stemming from the fund's trading activity prompted by purchases or redemptions.
- **Disclosure.** A fund would be required to increase disclosure around its policies for meeting redemptions, including specifying the typical payment period. New Form N-PORT (itself proposed only in May) would be expanded to include detailed, public liquidity information, notably the new position level liquidity classifications.

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The comment period for the proposed rules runs for 90 days after the proposal's publication in the Federal Register.

Current Regulatory Framework

Section 22(e) of the Investment Company Act generally requires an open-end SEC-registered investment company – often referred to as a mutual fund – to pay shareholders for securities of the fund tendered for redemption within seven days of their tender. This is a hallmark feature of mutual funds and necessarily means that a fund must be able to convert some portion of its portfolio holdings into cash on a frequent basis as needed to meet redemptions. Related requirements include:

- **Rule 15c6-1.** For a fund whose shares are redeemed through a broker dealer, there is the overlay of Rule 15c6-1 under the Securities Exchange Act, which establishes a three-day settlement period for security trades effected by a broker or a dealer.¹
- **Rule 22c-1.** Often called the “forward pricing” rule, Rule 22c-1 under the Investment Company Act requires funds, their principal underwriters and dealers to sell and redeem fund shares at a price based on the current NAV next computed after receipt of an order to purchase or redeem fund shares. As the SEC notes as one basis for its emphasis on short-term liquidity, this is notwithstanding that fund assets may be bought or sold in subsequent days in order to implement the share purchase or redemption.
- **15% guideline.** Longstanding SEC guidelines generally limit a mutual fund's aggregate holdings of “illiquid assets” to 15% of the fund's net assets.² Under this guidance, a portfolio security or other asset is considered illiquid if it cannot be sold or disposed of in the ordinary course of business within seven days at approximately the value at which the fund has valued the investment.

¹ In a 1995 staff no action letter, the SEC staff expressed the view that because rule 15c6 1 under the Exchange Act applies to broker dealers and does not apply directly to funds, the implementation of T+3 pursuant to Rule 15c6 1 did not change the standards for determining liquidity, which were based on the requirements of Section 22(e) of the Investment Company Act. The staff noted, however, that as a practical matter, many funds have to meet redemption requests within three business days because a broker dealer is often involved in the redemption process. See Letter from Jack W. Murphy, Associate Director and Chief Counsel, Division of Investment Management, SEC, to Paul Schott Stevens, General Counsel, Investment Company Institute (May 26, 1995), available at <http://www.sec.gov/divisions/investment/noaction/1995/ici052695.pdf>, (“May 1995 Staff No Action Letter”).

² Revisions of Guidelines to Form N-1A, Investment Company Act Release No. 18612 (Mar. 12, 1992) [57 FR 9828 (Mar. 20, 1992)].

- **Rule 2a-7.** Under Investment Company Act Rule 2a-7, money market funds must maintain sufficient liquidity to meet reasonably foreseeable redemptions, generally at least 10% of their portfolios in assets that provide daily liquidity and at least 30% of their portfolios in assets that provide weekly liquidity. The rule also requires that a money market fund may not acquire any illiquid security if, immediately after the acquisition, the fund would have invested more than 5% of its total assets in illiquid securities. (Rule 2a-7 is applicable only to money market funds. Since those funds are not subject to the current proposed rules, it is discussed here only for context.)

Liquidity Risk Management Programs – Proposed Rule 22e-4

Each fund covered by proposed new Rule 22e-4 – all open-end mutual funds and ETFs, but not money market funds or unit investment trusts – would adopt and implement a written liquidity risk management program. “Liquidity risk” would be defined for these purposes as the risk that a fund could not meet requests to redeem shares issued by the fund that are expected under normal conditions, or are reasonably foreseeable under stressed conditions, without materially affecting the fund’s net asset value.³

As proposed, a liquidity risk management program would have at least these required elements:

- **Portfolio liquidity classification** – classification, and ongoing review of the classification, of the liquidity of each of the fund’s positions in a portfolio asset (or portions of a position in a particular asset);
- **Risk assessment** – assessment and periodic review of the fund’s liquidity risk; and
- **Risk management around a set minimum of liquid assets** – management of the fund’s liquidity risk, including the investment of a set minimum portion of net assets in assets that the fund believes are convertible to cash within three business days at a price that does not materially affect the value of that asset immediately prior to sale.

For funds organized as part of multi-series vehicles, each series would need a liquidity risk management program tailored to its own liquidity risk.

Classifying Liquidity of a Fund’s Portfolio Positions

As proposed, a fund would classify the liquidity of each of the fund’s positions in a portfolio asset (or portions of a position in a particular asset) and review these liquidity classifications on an ongoing basis. In doing so, a fund would be required to consider the number of days within which a fund’s position in a portfolio asset (or portions of a position in a particular asset) would be convertible to cash at a price that does not materially affect the value of that asset immediately prior to sale.

Liquidity Categories

Based on its determination of the number of days within which the fund could convert its position in an asset to cash under this standard, the fund would classify each of its positions in a portfolio asset into one of six liquidity categories:

- Convertible to cash within 1 business day.
- Convertible to cash within 2-3 business days.
- Convertible to cash within 4-7 calendar days.

³ Proposed rule 22e-4(a)(7).

- Convertible to cash within 8-15 calendar days.
- Convertible to cash within 16-30 calendar days.
- Convertible to cash in more than 30 calendar days.

Significantly, the SEC intends that classification be on a share by share basis. For example, if a fund holds a block of an issuer's shares, it might determine that a number of those shares (e.g., the first 50%) are convertible to cash in one period with the remainder convertible to cash in a longer period.

Although the SEC is not proposing an approach that presumes that certain asset classes fall within particular liquidity categories, the agency notes that if a fund is an outlier with respect to its liquidity classifications, agency staff would be able to identify this based on the fund's new proposed reporting on Form N-PORT (as described later in this alert). If experience in other contexts is any guide, a fund flagged as such an outlier may be contacted by the SEC staff with a request to explain the fund's thinking.

Factors to Consider in Classifying Liquidity of a Position

When classifying the liquidity of its position, a fund would be required to take at least the following factors into account, to the extent applicable:

- Existence of an active market for the asset, including whether the asset is listed on an exchange, as well as the number, diversity and quality of market participants;
- Frequency of trades or quotes for the asset and average daily trading volume of the asset (regardless of whether the asset is a security traded on an exchange);
- Volatility of trading prices for the asset;
- Bid-ask spreads for the asset;
- Whether the asset has a relatively standardized and simple structure;
- For fixed income securities, maturity and date of issue;
- Restrictions on trading of the asset and limitations on transfer of the asset;
- The size of the fund's position in the asset relative to the asset's average daily trading volume and, as applicable, the number of units of the asset outstanding; and
- Relationship of the asset to another portfolio asset.

If a fund lacks pertinent information about a particular portfolio position, the fund would be expected to look to similar assets as a proxy.

Ongoing Review

Proposed Rule 22e-4(b)(2)(i) would require a fund to review the liquidity classification of each of the fund's portfolio positions on an ongoing basis. In doing so, the SEC believes a fund generally should have policies and procedures for identifying market-wide developments, as well as security- and asset-class-specific developments that could demonstrate a need to change the liquidity classification of a portfolio position. For instance, relevant market-wide developments could include changes in interest rates or other macroeconomic events, market-wide volatility, market wide flow changes, dealer inventory or capacity changes and extraordinary events such as natural disasters or political upheaval. Security- and

asset-class specific developments would include corporate events (such as bankruptcy, default or delisting, as well as reputational events) and regulatory changes affecting certain asset classes. Any of these developments could cause changes, for example, in the frequency of trades or quotes for a particular asset, as well as changes to that asset's trading volume, price volatility and bid-ask spreads. Beyond this guidance, there would be no prescribed review procedures (though the proposed monthly Form N-PORT disclosure cycle may create a practical incentive for at least monthly reviews); nor does the proposal incorporate any specific developments that must be monitored for.

Assessing and Managing a Fund's Liquidity Risk

As already noted, "liquidity risk" would be defined as the risk that a fund could not meet requests to redeem shares issued by the fund that are expected under normal conditions, or are reasonably foreseeable under stressed conditions, without materially affecting the fund's net asset value. The SEC believes a fund's liquidity risk will depend on a variety of factors, including, among others, its cash flows, investment strategy, portfolio liquidity, use of borrowings and derivatives, cash (and cash equivalents) on hand and borrowing arrangements.

Taking into account these types of factors, which are further detailed below, proposed Rule 22e-4(b)(2)(iii) would require a fund to assess and periodically review its liquidity risk. The fund then would be required to manage its liquidity risk based on that assessment, including by:

Assessing Liquidity Risk

The proposed rule would require each fund to take at least the following factors into account, as applicable, in assessing the fund's liquidity risk:

- Short-term and long-term cash flow projections, taking into account the following considerations:
 - Size, frequency and volatility of historical purchases and redemptions of fund shares during normal and stressed periods;
 - The fund's redemption policies;
 - The fund's shareholder ownership concentration;
 - The fund's distribution channels; and
 - The degree of certainty associated with the fund's short-term and long-term cash flow projections.
- The fund's investment strategy and liquidity of portfolio assets;
- Use of borrowings and derivatives for investment purposes; and
- Holdings of cash and cash equivalents, as well as borrowing arrangements and other funding sources.

Periodic Review of Liquidity Risk

The proposed rule would require each fund to periodically review the fund's liquidity risk, taking into account the factors used in assessing liquidity risk. Beyond reassessing the factors, the proposed rule does not include prescribed review procedures, nor does it specify the required risk review period (though there is a required semi-annual review of the three-day liquid asset minimum and an annual board reporting requirement) or incorporate specific developments that a fund should consider as part of its review. The SEC suggests that a fund might consider whether its periodic review procedures should include procedures for evaluating regulatory, market-wide and fund-specific developments affecting each of the factors. In addition, the SEC advises that a fund's liquidity risk review procedures could specify that certain

circumstances giving rise to a revision of a portfolio asset's liquidity classification could necessitate a review of the fund's liquidity risk.

Portfolio Liquidity: Minimum Investments in Three-Day Liquid Assets

a. Setting the Minimum

Again, each fund would set its own tailored "three-day liquid asset minimum" as part of its liquidity risk management program. As proposed, the fund's three-day liquid asset minimum would be defined as the percentage of the fund's net assets to be invested in three-day liquid assets.⁴

In determining its three-day liquid asset minimum, a fund would be required to consider the liquidity risk factors described above (fund flows, investment strategy, etc.). A fund's board would be required to approve the fund's three-day liquid asset minimum, including any changes to the minimum over time, and a fund would be required to maintain a written record of how the fund's three-day liquid asset minimum was determined, including an assessment of each of the listed factors.

b. Compliance with the Minimum

Under proposed Rule 22e-4(b)(2)(iv)(C), a fund would not be permitted to acquire any less liquid asset if, immediately after the acquisition, the fund would have invested less than its three-day liquid asset minimum in three-day liquid assets. This provision of proposed rule 22e-4 thus would limit the acquisition of less liquid assets if such acquisition would result in the fund holding a smaller percentage of its net assets in three-day liquid assets than the percentage representing its three-day liquid asset minimum. The provision would not, however, require a fund to constantly have invested a certain portion of its net assets in three-day liquid assets. For example, if a fund's investments in three-day liquid assets were to temporarily drop below the fund's three-day liquid asset minimum, the proposed rule would require the fund to acquire only three-day liquid assets until its investments in three-day liquid assets reach the fund's three-day liquid asset minimum, but would not require the fund to divest less liquid assets and reinvest the proceeds in three-day liquid assets.

c. Periodic Review of the Minimum

Under proposed Rule 22e-4(b)(2)(iv)(B), each fund would be required to periodically review the adequacy of the fund's three-day liquid asset minimum, and in conducting this review would be required to take into account the factors a fund would be required to consider in determining its three-day liquid asset minimum. A fund would be required to complete this review no less frequently than semiannually, but could establish a more frequent periodic review period, and in addition could review the three-day liquid asset minimum even more frequently on an ad-hoc basis as conditions demand. The fund's investment adviser or officers administering the fund's liquidity risk management program would be required to submit written reports to the fund's board concerning the adequacy of the fund's liquidity risk management program, including the fund's three-day liquid asset minimum, and the effectiveness of its implementation.

⁴ A three-day liquid asset would be proposed as cash held by a fund and any position of a fund in an asset (or portion of the fund's position in an asset) that the fund believes is convertible into cash within three business days at a price that does not materially affect the value of that asset immediately prior to sale. See proposed Rule 22e-4(a)(8). A fund's three-day liquid asset minimum would apply at the fund or series level, not at a class level.

Portfolio Liquidity: Limitation on Funds' Investments in "15% Standard Assets"

Effectively codifying the existing 15% illiquid test established by past SEC guidance, proposed rule 22e-4(b)(2)(iv)(D) would prohibit a fund from acquiring any "15% standard asset" if, immediately after the acquisition, the fund would have invested more than 15% of its net assets in 15% standard assets. The provision would not require a fund to divest any holdings if 15% standard assets rise above 15% of its net assets.

As proposed, a 15% standard asset would be defined as any asset that may not be sold or disposed of in the ordinary course of business within seven calendar days at approximately the value ascribed to it by the fund. For purposes of this definition, a fund would not be required to take into account the size of the fund's position in the asset or the time period associated with receipt of proceeds of sale or disposition of the asset.

Policies and Procedures Regarding Redemptions In-kind

The SEC believes that, as part of a fund's management of its liquidity risk, a fund that engages in or reserves the right to engage in in-kind redemptions should adopt and implement written policies and procedures regarding in-kind redemptions, and this requirement has been included in the proposed rule. The SEC would expect that these policies and procedures would address the process for redeeming in kind, as well as the circumstances under which the fund would consider redeeming in kind.

Board Approval and Designation of Program Administrative Responsibilities

Initial Approval of Liquidity Risk Management Program

Proposed rule 22e-4(b)(3)(i) would require a fund to obtain initial approval of its written liquidity risk management program from the fund's board of directors, including a majority of independent directors. This approval is required to include a specific approval of the fund's three-day liquid asset minimum.

Directors may satisfy their obligations with respect to this initial approval by reviewing summaries of the liquidity risk management program prepared by the fund's investment adviser or officers administering the program, legal counsel or other persons familiar with the liquidity risk management program. The summaries should familiarize directors with the salient features of the program and provide them with an understanding of how the liquidity risk management program addresses the required assessment of the fund's liquidity risk, including how the fund's investment adviser or officers administering the program determined the fund's three-day liquid asset minimum. The SEC suggests that a board will consider the adequacy of the fund's liquidity risk management program in light of the fund's assessed liquidity risk and recent experiences regarding the fund's liquidity, including any redemption pressures experienced by the fund.

Approval of Material Changes to Liquidity Risk Management Program and Oversight of the Three-Day Liquid Asset Minimum

Proposed Rule 22e-4(b)(3)(i) would require a fund to obtain approval of any material changes to the fund's liquidity risk management program, including changes to the fund's three-day liquid asset minimum, from the fund's board of directors, including a majority of independent directors. The fund's board also would be responsible under the proposed rule for reviewing a written report from the fund's investment adviser or officers administering the fund's liquidity risk management program, provided no less frequently than annually, that reviews the adequacy of the fund's liquidity risk management program, including the fund's three-day liquid asset minimum, and the effectiveness of its implementation. The SEC states that this aspect of the proposed rule is designed to facilitate board oversight over the adequacy and effectiveness of the fund's liquidity risk management program, including the three-day liquid asset minimum and whether the three-day liquid asset minimum is providing an appropriate level of minimum liquidity to the fund in light of changes in the markets, the fund and its shareholder base over time. To the extent that the board is being asked to approve a change in a fund's three-day liquid asset minimum, the SEC suggests that the written report should also provide directors

with an understanding of how a change to the fund's three-day liquid asset minimum was determined to be appropriate. The SEC believes that this review and its related report will provide the board with sufficient information to provide oversight over the adequacy and effective implementation of the fund's liquidity risk management program.

Designation of Administrative Responsibilities to Fund Investment Adviser or Officers

Proposed Rule 22e-4(b)(3)(iii) would require a fund to designate the fund's investment adviser or officers (who, for this purpose, may not be solely portfolio managers of the fund) as persons responsible for administering the fund's liquidity risk management program. Designation must be approved by the fund's board of directors.

Swing Pricing

"Swing pricing" refers to a process for adjusting a fund's NAV to effectively pass on the market impact costs, dealer spreads, and transaction fees and charges stemming from net capital activity (i.e., flows into or out of the fund) to the shareholders associated with that activity. The pricing adjustments are intended to protect other shareholders from dilution arising from these costs.

In presenting the possibility of swing pricing, the SEC is introducing what would be a wholly new concept for US mutual funds and one that carries a broad range of new operational and disclosure complexities. In its discussion, the agency draws heavily on European data relating to UCITS, where in some markets swing pricing is customary and widespread.

Under proposed rule 22c-1(a)(3), mutual funds (but not ETFs or money market funds) would be permitted to establish and implement swing pricing policies and procedures that would require a fund to adjust its NAV under certain circumstances. Before doing so, the fund's board, including a majority of independent directors, must have approved policies and procedures that include certain specified elements, as follows:

- A specified percentage of the fund's NAV known as the "swing threshold," which, when net purchases or redemptions exceed the threshold, will trigger application of swing pricing; and
- A "swing factor" amount by which the fund will adjust its NAV either upward (in the event net purchases exceed the threshold) or downward (in the event net redemptions exceed the threshold). The swing factor might vary depending on the degree to which the swing threshold is exceeded.

The upward adjustment when net purchases exceed the swing threshold is intended to cause purchasing shareholders to cover near-term costs associated with the fund investing in additional portfolio assets. Conversely, the downward adjustment when net redemptions exceed the threshold is intended to cause redeeming shareholders to cover near-term costs associated with the fund selling portfolio assets. Under the proposed rule, in-kind purchases and in-kind redemptions would be excluded from the calculation of net purchases and net redemptions for purposes of determining whether a fund's net purchases or net redemptions exceed its swing threshold.

In specifying its swing threshold, a fund would be required to consider:

- The size, frequency and volatility of historical net purchases or net redemptions of fund shares during normal and stressed periods;
- The fund's investment strategy and the liquidity of the fund's portfolio assets;
- The fund's holdings of cash and cash equivalents, as well as borrowing arrangements and other funding sources; and
- The costs associated with transactions in the markets in which the fund invests.

Swing pricing requires the net cash flows for a fund to be known, or estimated using information obtained after reasonable inquiry, before determining whether to adjust the fund's NAV on any particular day (and, if the fund's swing factor varies depending on its net flows, to determine the swing factor that the fund will use to adjust its NAV).

A fund would be required to review its swing pricing policies and procedures, no less frequently than annually, with any material changes subject to board approval. Under the procedures, the board would also be required to designate the fund's adviser or officers responsible for administering the policies and procedures. There would also be recordkeeping requirements relating to swing pricing and any NAV adjustments made pursuant to the policies and procedures.

Disclosure and Reporting Requirements Regarding Liquidity Risk and Liquidity Risk Management

Proposed Amendments to Form N-1A

Among other things, the proposed amendments to Item 11 of Form N-1A would require a fund to disclose in its prospectus the number of days in which the fund will pay redemption proceeds to redeeming shareholders. If the number of days in which the fund will pay redemption proceeds differs by distribution channel, the fund would be required to specify its payment schedule by channel. Proposed amendments would also require a fund to disclose the methods that the fund uses to meet redemption requests, specifying differences that might be applied in normal versus stressed market conditions.

The SEC also proposes to amend Item 6 of Form N-1A, which would require a fund that uses swing pricing to explain the circumstances under which swing pricing would be used as well as the effects of using swing pricing.

Proposed Amendments to Proposed Form N-PORT

On May 20, 2015, the SEC proposed requiring registered management investment companies and ETFs organized as unit investment trusts, other than registered money market funds or small business investment companies, to electronically file with the SEC monthly portfolio investment information on proposed Form N-PORT.⁵ Part C of proposed Form N-PORT would require a fund and its consolidated subsidiaries to disclose its schedule of investments and certain information about the fund's portfolio of investments. The proposed amendments would add Item C.13 to Part C of proposed Form N-PORT, which would require a fund to indicate the liquidity classification of each of the fund's positions in a portfolio asset. Funds would be required to indicate such liquidity classification using the categories as specified in proposed rule 22e-4, discussed previously.

The SEC also proposes to add an Item B.7 to Part B of proposed Form N-PORT to require each fund to disclose its "three-day liquid asset minimum," as described above.

Proposed Amendments to Proposed Form N-CEN

As proposed, all registered investment companies, including money market funds but excluding face amount certificate companies, would be required to file Form N-CEN and provide "census-type" information annually. The SEC would amend proposed Form N-CEN to allow it and others to track certain liquidity risk management practices that it expects funds to use on a less frequent basis than the day-to-day portfolio construction techniques captured by proposed Form N-PORT. More specifically, the amendments would add an item to Part C of proposed Form N-CEN that would

⁵ Submissions on Form N-PORT would be filed no later than 30 days after the close of each month. As proposed, only information reported for the third month of each fund's fiscal quarter on Form N-PORT would be publicly available, and such information would not be made public until 60 days after the end of the third month of the fund's fiscal quarter.

include certain questions regarding the use of lines of credit, interfund lending, interfund borrowing and swing pricing. Proposed Item 44 also would require a fund to report whether it engaged in interfund lending or interfund borrowing during the reporting period, and, if so, the average amount of the interfund loan when the loan was outstanding and the number of days that the interfund loan was outstanding. Finally, Item 44 would require a fund other than a money market fund to disclose whether it engaged in swing pricing during the reporting period.

Compliance Dates

Liquidity Risk Management Program

For larger entities (namely, 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) the SEC is proposing a compliance date of 18 months after the effective date to comply with proposed Rule 22e-4’s new program requirements.

For smaller entities (i.e., 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 the most recent fiscal year), the SEC is proposing to provide for an extra 12 months (or 30 months after the effective date).

Swing Pricing

As reliance on proposed Rule 22c-1(a)(3) would be optional, a compliance period would not be necessary. Therefore, the SEC expects that a fund would be able to rely on the rule, if adopted, as soon as the fund could comply with proposed rule requirements and related records, financial reporting and prospectus disclosure requirements.

Amendments to Form N-1A

Except with respect to the proposed amendments to Form N-1A related to swing pricing (discussed above), if the other proposed amendments to Form N-1A are adopted, the SEC expects to require all initial registration statements on Form N-1A, and all post-effective amendments that are annual updates to effective registration statements on Form N-1A, filed six months or more after the effective date, to comply with the proposed amendments to Form N-1A.

Amendments to Form N-PORT

Similar to the tiered compliance dates for the liquidity classification requirements for fund liquidity risk management programs under proposed rule 22e-4 (discussed above), the SEC expects to provide for a tiered set of compliance dates based on asset size for the proposed amendments to proposed Form N-PORT. For larger entities it is proposing a compliance date of 18 months after the effective date to comply with the new reporting requirements. For smaller entities, the SEC is proposing to provide for an extra 12 months (or 30 months after the effective date) to comply with the new reporting requirements.

Amendments to Form N-CEN

If Form N-CEN and the proposed amendments to the form are adopted, the SEC is proposing a compliance date of 18 months after the effective date to comply with the new reporting requirements.

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This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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