STAFF ISSUES FAQS REGARDING LIQUIDITY RISK MANAGEMENT PROGRAMS

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U.S. Investment Management Alert

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On January 10, 2018, the staff of the Division of Investment Management at the U.S. Securities and Exchange Commission ("SEC") issued guidance related to Rule 22e-4 (the "Liquidity Rule" or "Rule"), which will require open-end registered funds to adopt Liquidity Risk Management Programs ("LRM Programs"), in the form of Frequently Asked Questions ("FAQs"). [1] The Liquidity Rule was adopted in October 2016 and becomes effective for funds with assets under management exceeding $1 billion on December 1, 2018. [2] The FAQs address two topics: 1) the scope of responsibilities that may be delegated under an LRM Program to subadvisers and instances where there may be differences in the liquidity classification of an investment, and 2) what it means to be an "In-Kind ETF."

The Liquidity Rule requires funds to adopt an LRM Program for the classification of their portfolio holdings according to each holding's anticipated liquidity and to designate a person to administer the LRM Program (a "Program Administrator"). The Rule also generally requires funds to maintain a portion of their portfolios in "highly liquid" investments. After the SEC adopted the Rule, several questions arose regarding LRM Programs for subadvised funds and how differences in the scope of responsibilities assigned to subadvisers and liquidity determinations can be resolved. FAQs 1–8 seek to address such questions.

Under the Rule, exchange-traded funds ("ETFs") whose redemptions include only a *de minimis* amount of cash ("In-Kind ETFs") are exempt from the Rule's most onerous requirements—maintaining a highly liquid investment minimum and classifying the liquidity of each portfolio investment—because the SEC determined them not to be subject to the same liquidity risks as funds that redeem with more cash. After the SEC adopted the Rule, several questions arose as to how an ETF could determine if it qualifies for "In-Kind ETF" status. FAQs 9–15 seek to address such questions.

This alert first discusses the FAQs regarding subadvised funds and then discusses the FAQs regarding In-Kind ETFs.

SUBADVISED FUNDS: DELEGATING LRM PROGRAM RESPONSIBILITIES AND ADDRESSING DIFFERENT LIQUIDITY CLASSIFICATIONS OF THE SAME INVESTMENT

Subadvised funds preparing to implement an LRM Program have questioned whether program administrative or other responsibilities, such as classifying the liquidity of portfolio investments, can be delegated to a subadviser and, if so, how a Program Administrator might resolve conflicts stemming from that delegation. Specifically, Program Administrators faced uncertainty regarding the extent to which LRM Program responsibilities could be delegated and whether they would be required to reconcile conflicting classifications of the same security held by multiple funds in the same complex or even by different sleeves of the same fund.

Delegation to a Subadviser. The staff confirms that Program Administrators have flexibility to delegate responsibilities under a fund's LRM Program to subadvisers, subject to appropriate oversight. For example, a Program Administrator could delegate the responsibility for classifying the liquidity of portfolio investments held by a subadvised portion of a fund to the subadviser. If deemed appropriate, a fund's subadviser could also be designated as the Program Administrator. The staff notes that a fund's LRM Program should address the scope of any permitted delegation and included procedures for overseeing delegates.

Advisers or Subadvisers with Duties Under Multiple, Different LRM Programs. The staff notes that it is the responsibility of funds and not advisers to adopt LRM Programs, but that the Rule clearly contemplates a role for advisers in handling LRM Program responsibilities. Thus an adviser or subadviser may have responsibilities under LRM Programs that differ from one another, whether they are multiple LRM Programs of the same fund complex or LRM Programs of different fund complexes. In this case, the staff states that (1) a fund's board-approved LRM Program should control how an adviser or subadviser carries out its responsibilities with respect to that particular fund, and (2) the adviser or subadviser is under no obligation to reconcile the elements of those different programs, the programs' methodologies, or the liquidity classifications that result.

Differing Liquidity Classifications of the Same Portfolio Investment. The staff confirms that liquidity classifications of the same investment can appropriately vary from fund to fund, including funds in the same complex, if different methodologies and assumptions, such as anticipated trading size, are applied in the analysis. If a fund's adviser and subadviser reach differing conclusions about an investment's liquidity category, the staff believes that the fund's LRM Program could address how the fund would resolve those differences. For example, the LRM Program could provide that a specified party's determination (the Program Administrator, adviser, or subadviser) would control, or that the least liquid category would be used.

Similarly, the staff recognizes that for funds with a "manager of managers" structure, where multiple subadvisers each have responsibility for a distinct fund "sleeve," subadvisers may classify the same investment differently. The staff believes that neither the fund, Program Administrator, nor the adviser or subadvisers would be obligated to resolve these differences for *compliance* purposes—that is, for purposes of monitoring compliance with a fund's highly liquid investment minimum and the 15% limit on illiquid investments. However, for *reporting* purposes, a single fund cannot classify the same investment on Form N-PORT in different liquidity categories, even if it is held in different sleeves. Thus, the staff believes that funds must have a process for selecting a single classification for Form N-PORT reporting purposes. The staff does not endorse a particular methodology for establishing a single classification in situations of conflict, but, for the purpose of example, states that a fund with multiple subadvised sleeves could:

- Adopt the classification of the subadviser with the largest position in the investment;
- Calculate a weighted average (based on each subadviser's classification and its respective position size) and round to the nearest classification; or
- Use the most conservative (i.e., least liquid classification).

Finally, the staff encourages a fund that classifies the same investment differently for compliance purposes, but reports a single classification on Form N-PORT, to note this fact in the Explanatory Notes section of that form, and to describe the method it uses to resolve classification differences.

While the staff's guidance offers some clarity and flexibility for subadvised funds, it also emphasizes the need for clear policies related to delegation, classification, and reporting. Program Administrators responsible for subadvised funds should develop a framework for tracking which party is responsible for the classification of which investments and how conflicts in liquidity classifications will be reconciled for reporting purposes. Additionally, Program Administrators should determine how they intend to describe that reconciliation in the Explanatory Note in Form N-PORT.

IN-KIND ETFS

As explained above, under the Rule, ETFs whose redemptions include only a *de minimis* amount of cash ("In-Kind ETFs") are exempt from many of the most onerous requirements otherwise imposed by the Rule. However, before FAQs 9–15, there was considerable uncertainty regarding how an ETF could determine if it qualifies for "In-Kind ETF" status. The FAQs go a considerable distance in addressing such uncertainty.

Most importantly, in the FAQs the staff clarifies the Commission's statement in the Adopting Release that an ETF that loses its status as an In-Kind ETF by issuing redemptions inclusive of more than a *de minimis* amount of cash "may be able to conclude that it qualifies as an In-Kind ETF in later years." The suggestion implicit in this statement—that an ETF's loss of In-Kind ETF status cannot be cured until "later years"—sounded alarm bells throughout the industry. Accordingly, the staff's clarification that "no specific period of time" must pass for an ETF to determine that it again qualifies for In-Kind ETF status is likely to lead the industry to breathe a sigh of relief. Further, when determining whether it may (re)claim In-Kind ETF status, the staff indicated that an ETF should focus on the facts and circumstances that led it to operate outside of In-Kind ETF status and its future ability, notwithstanding market conditions, to honor redemptions in kind. The staff seems to acknowledge that an ETF may suffer an "extraordinary one-time event that is unlikely to occur again" and that such an event, therefore, should not be the basis for a loss of In-Kind ETF status.

With regard to an ETF that does lose its status as an In-Kind ETF, the staff stated that the ETF must come into compliance with the requirements of an LRM Program "as soon as reasonably practicable," and it must indicate its current status in Item E.5 of Form N-CEN.

With regard to new ETFs, the FAQs confirm that they, too, may claim In-Kind ETF status notwithstanding their lack of any redemption history that evidences their practice of redeeming in kind. In this regard, the FAQs acknowledge that, while an ETF's "backward-looking redemption history [will] ordinary [be] relevant" to the determination of whether the ETF can deem itself to be an In-Kind ETF, a new ETF (or an existing ETF that materially changes its redemption practices) may also qualify as an In-Kind ETF if its policies and procedures restrict its usage of cash in redemptions and one can reasonably conclude that its future redemptions will include only *de minimis* amounts of cash.

With respect to what constitutes a *de minimis* amount of cash, the FAQs provide still more welcome guidance. First, the FAQs confirm that, when testing for compliance with the *de minimis* cash requirement, an ETF may exclude the amount of cash in redemption proceeds that is proportionate to the ETF's cash position, irrespective of amount ("Proportional Exclusion").

Second, the FAQs provide somewhat of a bright-line test for ETFs as to what the staff considers a *de minimis* amount of cash in this context. Specifically, the FAQs indicate that the staff believes that where, overall, cash represents 5% or less of an ETF's redemption proceeds (plus the Proportional Exclusion), the cash amount would be *de minimis* and, therefore, the ETF could qualify for In-Kind ETF status. In fact, in the FAQs, the staff indicates its belief that, under certain facts and circumstances, the cash portion of an ETF's overall redemption proceeds could be up to 10% (plus the Proportional Exclusion) and still qualify as *de minimis*. The staff does not believe, however, that if more than 10% of an ETF's overall redemption proceeds (subject to the Proportional Exclusion) consist of cash, such cash can appropriately be described as *de minimis*. In all cases, the staff emphasized the fact-specific nature of the determination as to whether the ETF is subject to "liquidity risks substantially similar to those of mutual funds." In this regard, the staff agreed that, under certain circumstances, an ETF could satisfy a redemption request entirely with cash (and without regard to the Proportional Exclusion) without losing its status as an In-Kind ETF, provided that the ETF (and not the Authorized Participant) was the party that determined to conduct an all-cash redemption and that the all-cash redemption did not result in the ETF exceeding the *de minimis* cash requirements established by its policies and procedures.

Third, with regard to testing compliance with the *de minimis* cash requirement, the staff indicated its belief that there are likely many reasonable approaches. However, the staff identified two potential reasonable approaches as follows:

- Test each individual redemption transaction, to ensure that each has no more than a *de minimis* cash amount (plus the Proportional Exclusion), or
- Test redemption transactions in their totality over some reasonable period of time to ensure that, on average, redemption proceeds include only a *de minimis* cash amount (plus the Proportional Exclusion). Note, however, the staff's view that "a reasonable period of time for a fund with frequent redemption basket activity might be a day or a week, while a reasonable period for a fund with less frequent redemption basket activity may be up to a month." Further, the staff stated expressly that it does not believe that using a period of time over a month would be reasonable, apparently, under any circumstances.

For ETFs seeking to qualify as In-Kind ETFs, the lynchpins of their analyses will be established by their policies and procedures. Per the staff's guidance in the FAQs, an ETF should describe in its policies and procedures the factors it will consider to determine whether it is an In-Kind ETF. The policies and procedures should be written with due consideration given to the typical portfolio holdings of the ETFs at issue and the potential for different types of market conditions. As indicated by the FAQs, each ETF's policies and procedures will need to provide the appropriate period(s) of time over which its redemption practices will regularly be assessed, including in light of its redemption history. ETFs may also want to consider how to address volatility in redemption activity, which may be particularly important if the frequency of their redemption transactions increases such that their measurement period may no longer be considered reasonable by the staff. In addition, to prepare for the potential loss of In-Kind ETF status, an ETF's policies and procedures should include a description of the factors that will be used to evaluate the cause of its lost status as either an extraordinary, one-time event or a material change to its analysis of its status. ETFs may also wish to include a timeline for coming into compliance with the Rule in the event that they lose In-Kind ETF status and a brief project plan for doing so.