ALERTS

Registered Investment Company Update: New Guidance on Liquidity Risk Management Programs

February 7, 2018

On Jan. 10, 2018, the staff of the Division of Investment Management of the SEC posted responses to a number of Frequently Asked Questions ("Staff FAQs") concerning liquidity risk management ("LRM") programs required to be implemented pursuant to new Rule 22e-4 under the Investment Company Act of 1940 ("1940 Act").[1] Under Rule 22e-4, adopted by the SEC in October 2016,[2] 1940 Act registered open-end management investment companies (other than money market funds) must adopt and implement written LRM programs that are reasonably designed to assess and manage liquidity risks.[3] Elements of these programs must generally include:

1. Assessment, management and periodic review of liquidity risk;
2. Classification of portfolio investments into one of four liquidity categories;
3. Establishment of a "highly liquid investment minimum"[4]; and
4. A 15 percent of net assets limit on the purchase of illiquid investments.

The Staff FAQs provide helpful guidance relating to the design of LRM programs for sub-advised funds (including multi-manager funds) and to issues uniquely associated with in-kind exchange-traded funds ("In-Kind ETFs").[5] They also provide guidance relevant to all funds that are subject to Rule 22e-4, particularly with respect to the delegation of responsibilities under the programs and variations in the classification of

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particular investments by different funds managed by the same adviser or sub-adviser.

General Guidance on LRM Programs

The Staff FAQs address various questions that may arise in connection with the design and operation of LRM programs, including with respect to:

- Delegation by LRM Program Administrators. Rule 22e-4 requires a fund's board of directors to approve the designation of a person or persons to administer its LRM program ("Program Administrator").[6] In the Staff FAQs, the SEC staff states that a Program Administrator may, subject to appropriate oversight, delegate specific responsibilities under an LRM program to other persons, including the sub-adviser of a fund (such as responsibility for determining the liquidity classifications of the fund's investments). The SEC staff notes in this regard that, because a fund has ultimate responsibility for complying with Rule 22e-4, a fund may wish to implement procedures regarding the scope of any delegation of responsibility and related conditions and a Program Administrator may wish to implement procedures relating to the oversight of persons to whom responsibilities are delegated. In addition, the SEC staff states that a person delegated responsibilities under an LRM program may sub-delegate portions of its responsibilities, subject to appropriate supervision.

- Management of Funds With Differing LRM Programs. The responses to the Staff FAQs recognize that, where an adviser or sub-adviser manages multiple funds (including multiple funds within the same fund complex) that have LRM programs that differ from one another, its responsibilities under these programs may differ. The SEC staff notes that, in these situations (i) an adviser or sub-adviser is not required to reconcile any varying elements of these programs relating to underlying methodologies, assumptions, practices or program outputs (e.g., the liquidity classifications of fund investments); and (ii) each fund's LRM program controls how the fund's adviser and any sub-adviser should carry out its responsibilities under Rule 22e-4.

- Variations in Liquidity Classifications Among Funds Within a Fund Complex. The SEC staff acknowledges that different funds may classify the same investment differently in assigning their investments to liquidity categories based on their analysis of relevant facts and

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circumstances, including consideration of market depth and the size of trades reasonably anticipated by a fund. It notes that, even as among funds within the same fund complex, different funds might classify a particular investment differently as a consequence of their use of differing methodologies and assumptions relating to the investment's market, trading, investment-specific characteristics and reasonably anticipated trade size.

- Handling Conflicts in Liquidity Classifications for Sub-Advised Funds. The SEC staff also addresses how sub-advised funds should deal with conflicts in the liquidity classification of an investment in circumstances where a fund's adviser and sub-adviser have reached different conclusions regarding the classification of a particular investment. In this regard, a fund's Program Administrator may delegate classification responsibility to either the adviser or the sub-adviser, in which case that entity's classification determination would be controlling. Alternatively, the Program Administrator may adopt an approach under which input from both the adviser and sub-adviser is considered, in which case the LRM program should establish a specific method for resolving differences between the conclusions of the adviser and sub-adviser. This might include a policy under which a specified party's determination would be controlling or use of another method, such as the use of a factor analysis or hierarchy or adopting of a policy to use the most conservative classification (i.e., the least liquid).

- Liquidity Classifications in Multi-Manager Funds. In the case of a multi-manager fund in which multiple sub-advisers manage separate "sleeves" of a fund's assets and each sub-adviser has been delegated responsibility for classifying investments in its respective "sleeve" into the appropriate liquidity category, the SEC staff recognizes that different sub-advisers may classify the same investment differently. It states that a fund's procedures could specify a process for resolving these differences, but noted that there is no obligation to resolve these differences for purposes of complying with Rule 22e-4 (including for purposes of complying with the fund's highly liquid investment minimum or with the 15 percent limit on investments in illiquid investments). However, any such differences would need to be resolved for purposes of a fund's reporting of liquidity classifications on Form N-PORT because the form does not permit a fund to report more than one liquidity classification for a particular investment.[7] In this regard, the SEC staff notes that a fund may use any reasonable method to resolve these

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differences, provided that the method is consistently applied. Permissible alternative approaches would include (i) using the classification determined by the sub-adviser managing the "sleeve" holding the largest position in the investment; (ii) using a classification determined by use of a weighted average of the differing classifications (based on each sub-adviser's classification and position size); or (iii) using the most conservative (i.e., least liquid) classification.[8]

In-Kind ETFs

Under Rule 22e-4, an In-Kind ETF is an exchange-traded fund that:

1. Is organized as an open-end management investment company;
2. Meets redemptions through in-kind transfers of securities, positions and assets other than a de minimis amount of cash; and
3. Publishes its portfolio holdings.

In-Kind ETFs are excepted from the requirements of Rule 22e-4 relating to the liquidity classification of portfolio investments and the establishment of a highly liquid investment minimum in recognition of the fact that they generally do not need to sell investments to pay redemptions. In its responses to the Staff FAQs, the SEC staff addresses the requirements that must be met to qualify as an In-Kind ETF.

In this regard, the SEC staff provides the following guidance for determining whether an exchange-traded fund satisfies redemptions by means of the in-kind distribution of assets other than a de minimis amount of cash:

- Treatment of Cash Positions. The inclusion of cash in redemption payments by an ETF in an amount corresponding to the cash position in the ETF's portfolio may be disregarded in determining whether the ETF's use of cash to pay redemptions is de minimis.[9]
- Treatment of Single Redemption Transactions for Cash. An ETF that engages in a single redemption transaction consisting entirely of cash is not precluded from qualifying as an In-Kind ETF. However, the decision to make payment for a redemption in cash must be at the ETF's discretion and not at the election of the authorized participant effecting the redemption.

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- Scope of the De Minimis Cash Exception. Although the release adopting Rule 22e-4 did not establish a bright line test for determining what constitutes a de minimis amount of cash, an ETF may determine that the use of cash in an amount constituting more than 5 percent of overall redemption proceeds is de minimis. The SEC staff believes it would be unreasonable to consider as de minimis cash exceeding 10 percent of overall redemption proceeds (excluding cash corresponding to the cash position in the ETF's portfolio).

- Determining What Constitutes a De Minimis Use of Cash. There are various approaches that an ETF might use to determine whether its use of cash in connection with redemptions is de minimis, including (i) testing each individual redemption transaction; or (ii) testing redemption transactions over some reasonable period of time. What constitutes a reasonable period of time for this purpose depends on the frequency of redemption activity, and could be a day or a week for an ETF with frequent redemptions or up to a month for an ETF with infrequent redemptions.

The SEC staff also provides the following guidance relating to an ETF ceasing to qualify as an In-Kind ETF:

- Consequences of Ceasing to Qualify as an In-Kind ETF. If an ETF no longer qualifies as an In-Kind ETF, the SEC staff would not recommend enforcement action if the ETF comes into compliance with the classification and highly liquid investment minimum requirements of Rule 22e-4 "as soon as reasonably practicable" after the ETF no longer qualifies as an In-Kind ETF. No guidance is provided, however, as to what period of time would constitute "as soon as reasonably practicable."

- Requalifying as an In-Kind ETF. There is no specified period of time that must elapse before an In-Kind ETF that ceases to qualify as such may again qualify. Such a determination must be made based on applicable facts and circumstances. However, an ETF that has lost its qualification could again avail itself of the exceptions for In-Kind ETFs if it makes a reasonable determination, based on its particular facts and circumstances, that the event causing it to lose its status as an In-Kind ETF was "an extraordinary one-time event that is unlikely to occur again." The factors that an ETF would consider in making these determinations should be set forth in its LRM program policies and procedures.

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Conclusion

The Staff FAQs provide helpful guidance by addressing various questions that may arise in connection with the design and operation of LRM programs. They include advice that is particularly useful for sub-advised funds (including multi-manager funds) and In-Kind ETFs, as well as advice relevant to all funds that are required to adopt LRM programs with respect to the delegation of responsibilities and the classification of investments.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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[1] The Staff FAQs are available on the SEC's website here.

[2] Investment Company Liquidity Risk Management Programs, ICA Release No. 32315 (Oct. 13, 2016).

[3] Funds that are part of a "group of related investment companies" having net assets of $1 billion or more ("larger fund groups") are required to adopt LRM programs no later than Dec. 1, 2018. Funds that are part of a group of related investment companies having net assets of less than $1 billion ("smaller fund groups") are required to adopt LRM programs no later than June 1, 2019. The term "group of related investment companies" is defined by Rule 0-10 under the 1940 Act as two or more management investment companies (including series thereof) that (i) hold themselves out to investors as related companies for purposes of investment and investor services; and (ii) either (a) have a common investment adviser or have investment advisers that are affiliated persons of each other or (b) have a common administrator.

[4] Funds that primarily hold assets that are "highly liquid investments," as defined by Rule 22e-4, are not required to establish a highly liquid investment minimum.

[5] Rule 22e-4 defines an In-Kind ETF as an exchange-traded fund that (i) is organized as an open-end management investment company; (ii) meets redemptions through in-kind transfers of securities, positions and assets other than a de minimis amount of cash; and (iii) publishes its portfolio holdings daily.

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[6] Paragraph (b)(2) of Rule 22e-4. The Program Administrator for a fund may be the fund's investment adviser or an officer or officers of the fund, but may not be solely portfolio managers of the fund. Paragraph (a)(13) of Rule 22e-4.

[7] In connection with the adoption of Rule 22e-4, the SEC is requiring that certain portfolio liquidity information be reported monthly on Form N-PORT. This form will replace Form N-Q and is designed to provide the SEC with information about a fund's portfolio holdings and the liquidity of its investments, as well as information regarding portfolio risk and the use of derivatives. Funds in larger fund groups are required to begin filing Form N-PORT no later than April 30, 2019 (reflecting data for March 2019) and, from June 1, 2018 until April 1, 2019, must satisfy their Form N-PORT reporting obligations by maintaining in their records the information required by Form N-PORT. Funds in larger fund groups must start maintaining the portfolio liquidity information required by Form N-PORT by Jan. 30, 2019 (reflecting data for December 2018). Funds in smaller fund groups are not required to begin filing Form N-PORT until April 30, 2020 (reflecting data for March 2020); however, these funds must begin maintaining in their records the portfolio liquidity information required by Form N-PORT by July 30, 2019 (reflecting data for June 2019). For more information regarding Form N-PORT filing and record maintenance requirements, please refer to "SEC Delays Form N-PORT Filing Requirements and Adopts Related Temporary Final Rule," *SRZ Alert*, Jan. 17, 2018, available here.

[8] Where a fund has multiple sub-advisers that have been given responsibility to classify investments within their respective "sleeves," the SEC staff stated that it encourages the fund to note this in the Explanatory Notes section of Form N-PORT and to explain in that section the method used by the fund to resolve differences in determination for Form N-PORT reporting purposes. Information in the Explanatory Notes section is non-public if related to a nonpublic item of Form N-PORT, such as the item requiring funds to report monthly position-level liquidity classifications.

[9] See ICA Release No. 32315, *supra*, at note 852 and accompanying text.

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