Client Alert

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SEC Releases Liquidity Rule FAQs

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The staff of the SEC's Division of Investment Management released this week a series of frequently asked questions (FAQs) regarding new Rule 22e-4 (the "Liquidity Rule"). The Liquidity Rule requires non-money market mutual funds and certain exchange-traded funds (ETFs) to adopt and implement a liquidity risk management (LRM) program designed to reduce the risk that funds will be unable to meet their redemption obligations and to mitigate dilution of the interests of fund shareholders.

The FAQs relate to sub-advised funds and ETFs that meet redemptions through in-kind transfers of securities, positions, and assets other than a *de minimis* amount of cash ("In-Kind ETFs"), and are a timely reminder that the compliance date for the Liquidity Rule is fast approaching. 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 their most recent fiscal year must implement an LRM program by December 1, 2018. Smaller entities have until June 1, 2019 to comply with the Liquidity Rule.

SUB-ADVISED FUNDS

Under the Liquidity Rule, a fund must designate a person (approved by the fund's board) to act as an LRM program administrator. The FAQs clarify that the program administrator can delegate certain responsibilities to a fund's sub-adviser. According to the SEC staff, the LRM program administrator should have flexibility to delegate to an "appropriate entity" responsibilities ranging from administering the whole LRM program to handling discrete functions. The staff made it clear, however, that a fund "at all times retains ultimate responsibility for complying" with the Liquidity Rule. The staff also recommended that a fund that authorizes its LRM program administrator to delegate responsibilities should implement policies and procedures clarifying the scope and conditions of such delegation.

The staff recognizes that advisers and sub-advisers may provide services to more than one fund or fund complex. As a result, an adviser or a sub-adviser may have different responsibilities under more than one LRM program. According to the FAQs, an adviser "is under no obligation to reconcile the elements of those programs; the programs' underlying methodologies, assumptions, or practices;" or the resulting liquidity classifications of fund investments. Moreover, the staff acknowledged that one result of funds having differing LRM programs is that different funds may classify the same investment differently, even if they have the same adviser or sub-adviser.

The FAQs address how a fund should resolve differences when a fund's adviser and its sub-adviser reach differing conclusions regarding a particular security's liquidity category. The staff said that the LRM program could specify that the decision of either the adviser or the sub-adviser will control how the fund classifies its investments. Alternatively, a fund could adopt an approach where both the adviser and the sub-adviser have input into the fund's liquidity classification. In that case, however, the staff expects a fund's policies and

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procedures to clearly address how the input of each of the adviser and the sub-adviser contributes to the fund's assessment of an investment's liquidity.

The FAQs also address a manager-of-managers structure, where sub-advisers manage their sleeves of a fund autonomously and may classify the same security in different liquidity categories. The staff takes the view that "neither the fund, program administrator, nor the adviser nor the sub-advisers with delegated LRM responsibilities would be under any obligation to resolve these differences for compliance purposes," although a fund could adopt policies and procedures to resolve such differences.

Whether such differences are resolved or not for compliance purposes, a fund must reconcile liquidity classification differences for reporting on new Form N-PORT. Accordingly, the fund's policies and procedures should include a process for selecting a single liquidity classification for each investment for reporting purposes. A fund can adopt any "reasonable method for resolving this difference, so long as the fund applies that method consistently."

ETFS

The FAQs clarify that an In-Kind ETF may exclude from its calculation of its *de minimis* cash the amount of cash in its redemption proceeds that is proportionate to its uninvested portfolio cash. In the staff's view, this is an "in-kind" redemption and not subject to the *de minimis* threshold.

The FAQs also clarify that an In-Kind ETF should define what constitutes a *de minimis* amount of cash in its policies and procedures and acknowledged that the *de minimis* threshold may differ among ETFs. The staff declined to provide a bright line test for determining the *de minimis* threshold but said it would be unreasonable, for purposes of qualifying as an In-Kind ETF, if an ETF's percentage of overall redemption proceeds paid in cash exceeds 10 percent. Notably, the 10 percent threshold would not necessarily "be representative of a *de minimis* amount in the context of other requirements under the federal securities laws."

The FAQs address whether meeting an authorized participant's (AP) redemption request entirely in cash would preclude an ETF from qualifying as an In-Kind ETF. The staff said that if an ETF makes the decision to meet an AP's redemption request in cash in its discretion that decision would not necessarily preclude the ETF from qualifying as an In-Kind ETF. If, however, an all cash redemption is made at the AP's election, that would leave the ETF open to the risk that it would need to sell investments to meet redemption demands in adverse liquidity situations. Since this is the risk that the rule is designed to address, such an ETF would not qualify as an In-Kind ETF.

The staff clarified that an ETF that loses its status as an In-Kind ETF is not precluded from subsequently availing itself of the In-Kind ETF exception contained in the Liquidity Rule. In order to do so, however, the board of the ETF must determine that the event that caused it to lose its status as an In-Kind ETF was an extraordinary one-time event.

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OUR TAKE

The FAQs make it clear that a fund or an ETF cannot delegate its responsibility under the Liquidity Rule to its adviser, sub-adviser or the LRM program administrator. It's also clear that the staff expects LRM policies and procedures to clearly detail how a fund will address different liquidity determinations that will necessarily arise in sub-advised funds and in large fund complexes. Moreover, a fund might deal differently with liquidity determinations for compliance purposes than it does for reporting purposes, resulting in discrepancies between internal and external reporting.

This additional complexity will increase the burden on not only compliance personnel and the LRM program administrators, but also on a fund's board. At minimum, the board will need to carefully evaluate the fund's policies and procedures and make a determination that they are (i) reasonably designed to meet the requirements of the Liquidity Rule and (ii) adequately address conflicts of interest inherent in resolving different liquidity determinations made by a fund's adviser and sub-adviser or deciding whether an ETF can continue to rely on the In-Kind ETF exception.

We understand that the Division of Investment Management is currently evaluating the responsibilities of fund boards. Here's one more responsibility to add to that list.

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