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Client Alert

January 24, 2018

SEC Releases Fund Liquidity Risk Management Programs Frequently Asked Questions

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On January 10, 2018, the staff of the Securities and Exchange Commission (SEC) Division of Investment Management released frequently asked questions (FAQs) concerning its liquidity risk management rules ("Liquidity Rules"). Specifically, the FAQs addressed ways that sub-advised funds and exchange-traded funds (ETFs) can comply with the Liquidity Rules, which the SEC will begin enforcing later this year.

The Liquidity Rules were adopted in 2016 and will require certain open-end management investment companies and ETFs to adopt and implement written liquidity risk management programs. However, ETFs that redeem all but a *de minimis* amount of their shares in kind and disclose their portfolio holdings daily ("In-Kind ETFs") are granted certain exemptions under the Liquidity Rules.

The FAQs provide important guidance to funds in connection with roles and duties of advisers and sub-advisers under the Liquidity Rules. They also clarify for ETF sponsors the amount of cash redemptions that the SEC will consider *de minimis* for purposes of determining In-Kind ETF status. These and other clarifications are summarized below.

Summary of Key Points for Funds and Roles of Advisers and Sub-Advisers

Roles for Advisers and Sub-Advisers

The Liquidity Rules require funds, and not advisers, to adopt and implement liquidity risk management programs. Nevertheless, the FAQs note that advisers and sub-advisers have roles under the program under both the final rule and adopting release.

Designation of Program Administrator

Under the Liquidity Rules, the Program Administrator is tasked with ensuring a fund's compliance with the Liquidity Rules and making liquidity classifications. Although the Liquidity Rules require funds to designate a Program Administrator, a fund has some flexibility in choosing the administrator and may select the fund's adviser and/or its sub-adviser(s).

Delegation of Responsibilities

Program Administrators may delegate responsibilities to appointees. Where delegation occurs, a fund should adopt policies and procedures that address the responsibilities and supervision of appointees. We believe that these policies and procedures should be part of the fund's compliance policies and procedures.

Reconciliation of Methodology Differences

An adviser or sub-adviser that has different responsibilities under the liquidity risk management programs of multiple funds does not need to reconcile those programs' elements, methodologies, assumptions, practices or outputs. Each fund board's liquidity risk management program will govern that fund's processes.

Asset Classification Differences

Different funds within the same fund complex may use different methodologies and assumptions for determining the liquidity of assets, and may therefore classify the same asset differently.

Disagreements Regarding Classifications

When a fund's adviser and sub-adviser are each responsible for making liquidity classifications and reach different conclusions about a particular asset, a fund's liquidity risk management program should state how such disagreements are resolved. The FAQs provide several examples for how the policies could address this issue, including but not limited to specifying which entity's determination should control.

Manager-of-Managers Structure

If a fund employs a manager-of-managers structure, and different managers within that same fund classify the liquidity of an asset differently, the fund does not need to resolve this discrepancy for purposes of complying with the Liquidity Rules. Nevertheless, the fund must report a single liquidity classification on Form N-PORT and should adopt policies for selecting which classification will be reported. Funds that have multiple liquidity classifications for an asset but that report a single classification on Form N-PORT should note this point on the explanatory notes section of Form N-PORT. The FAQs provide several non-exclusive examples of how these classification differences might be resolved.

Summary of Key Points for ETFs

The FAQs provide much-needed clarification for ETFs on the *de minimis* exception in the Liquidity Rules. Under these Rules, an ETF that qualifies as an In-Kind ETF is exempt from the liquidity bucketing and highly liquid investment minimum requirements. An In-Kind ETF is defined as one that meets redemptions through in-kind transactions of securities positions and assets other than *de minimis* amounts of cash. There has been considerable confusion in the industry as to the definition of "*de minimis*" in this context. The FAQs clarified that:

De Minimis Calculation

When determining what constitutes a *de minimis* amount for purposes of cash redemptions, an ETF may exclude from its calculations an amount of cash proportionate to the cash that it holds in its portfolio.

Testing Period for *De Minimis*

ETFs may take any reasonable approach to testing whether their redemptions in cash are *de minimis*, but must apply the approach consistently. The SEC believes that a reasonable testing period for a fund with frequent redemption basket activity may 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. Nevertheless, the SEC views any testing period that exceeds one month to be "unreasonable."

De Minimis Benchmarks

The SEC believes that an ETF paying less than 5 percent of its redemptions in cash may qualify as an In-Kind ETF, but that a fund paying more than 10 percent of its redemptions in cash would not. As for an amount between 5 percent and 10 percent, the staff believes that the ETF should evaluate its particular facts and circumstances, including its liquidity risk management plan and whether an amount in excess of 5 percent would present liquidity risks similar to a mutual fund. The staff emphasized that the 5 percent and 10 percent benchmarks for assessing whether cash redemption levels are reasonably *de minimis* are only applicable in the context of ETF redemptions and do not apply under other federal securities laws.

Cash Redemptions

As long as an ETF's cash redemptions do not exceed *de minimis* levels, it may qualify as an In-Kind ETF even where it makes a redemption payment to an authorized participant entirely in cash. In this situation, provided that the ETF has retained discretion to decide whether to provide cash or in-kind redemptions to an authorized participant, the staff believes that delivery of an all-cash redemption to an authorized participant does not necessarily jeopardize the fund's In-Kind ETF status. However, if the authorized participant has elected to receive cash from the ETF as a standard practice, the ETF would not qualify as an In-Kind ETF.

Loss of *De Minimis* Status

When an ETF loses its status as an In-Kind ETF, it must come into compliance with the Liquidity Rules as promptly as reasonably practicable after it no longer qualifies for the exception. Additionally, if an ETF determines that the event causing it to lose its In-Kind ETF status was a one-time event that is unlikely to occur again, the ETF does not need to wait a specific period of time before determining that it once again qualifies as an In-Kind ETF.

New ETFs

ETFs that have little or no operating history may qualify as In-Kind ETFs. The SEC believes that a fund's assessment of its In-Kind ETF status may be forward-looking, and that new ETFs may qualify as In-Kind ETFs based on their analysis of policies, procedures and expected redemption practices.

Practice Points

Policies and Procedures

It is likely that the SEC will want to review policies and procedures surrounding fund liquidity management programs in inspections going forward. It would therefore be prudent for funds, advisers and sub-advisers to put in place clear, written policies and procedures surrounding their liquidity risk management programs.

Based on these FAQs, the policies and procedures should include, among other things, clear delegation authority and steps for resolving any disagreements or conflicts among advisers and sub-advisers with respect to liquidity classifications. Multi-manager fund policies and procedures should clearly outline how decisions are reached with respect to the classifications reported on Form N-PORT when there are differences among the managers.

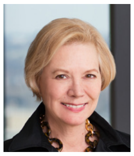
ETF boards and advisers will need to carefully document their *de minimis* cash determinations and policies and procedures related thereto as well as the supervisory controls that serve to qualify the ETF for In-Kind ETF status.

Board Determinations

Fund boards are required to approve the initial liquidity risk management program and the Program Administrator. Their decisions should be based on, among other things, a clear understanding of any delegated responsibilities and how advisers and sub-advisers will interact to make liquidity classification decisions, the supervisory programs in place, and how any conflicts will be resolved.

Investment Management Group

Primary Contacts



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